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UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES TINNEY, Appellant, vs. LAWRENCE E. WILSON, Warden, et al., Appellee.	)	No. 22266

APPELLEE'S BRIEF

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UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

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APPELLEE'S BRIEF

JURISDICTION

The jurisdiction of the United States District Court, Northern District of California, to entertain appellant's application for a writ of habeas corpus was conferred by section 2241 of Title 28, United States Code. The jurisdiction of this Court is conferred by section 2253 of Title 28, United States Code, which makes an order in a habeas corpus proceeding reviewable when, as here, a certificate of probable cause has issued.

STATEMENT OF THE CASE

This is an appeal from the order of the United States District Court, Northern District of California, denying appellant's petition for a writ of habeas corpus.

A. Proceedings in the State Courts.

On July 30, 1963, appellant was convicted of a violation of section 11530 of the California Health and Safety Code (possession of marijuana). He was sentenced to be imprisoned in the state prison for the term prescribed by law (CT 40). The conviction was appealed to the California Court of Appeal, Second Appellate District. That court affirmed on July 12, 1966 (RT 39a-391). A petition for a writ of habeas corpus challenging this conviction was denied by the California Supreme Court (RT 6-7).

B. Proceedings in the Federal Courts.

Two previous applications for the writ of habeas corpus have been filed in the United States District Court, Northern District of California, in actions number 46079 and 46763. Both were denied. The petition which resulted in this appeal was filed

on June 29, 1967 (RT 1). An order to show cause directed to appellee issued June 28, 1967 (RT 30), and a continuance was granted on July 14, 1967 (RT 31). On July 21, 1967, appellee filed a return to the order to show cause (RT 32) and appellant's traverse was filed on August 3, 1967 (RT 71). The District Court's order denying the writ of habeas corpus was entered September 18, 1967. At the same time, the court certified that probable cause to appeal existed (RT 88-89).

STATEMENT OF FACTS

The facts in this case are undisputed. They are related in the Clerk's and Reporter's transcripts of the proceedings in the California Superior Court which were lodged with the District Court and which are exhibits before this Court. The pertinent facts are detailed in the opinion of the California Court of Appeal attached to the return to the order to show cause (CT 39a-391). These recitals have not been challenged by petitioner and thus are conclusive of any factual issues. 28 U.S.C. § 2254(d).

The prosecution evidence was presented at the preliminary hearing. Appellant testified in his own

behalf at the trial. At the preliminary hearing counsel for appellant stipulated that if W. King had been called, he would be qualified as an expert forensic chemist, and would have testified that the cigarette contained in People's Exhibit No. 1 contained marihuana. (Cl. Tr. pp. 4-5).

David McGill testified that he was a police officer for the City of Los Angeles, attached to the Wilshire Vice Detail. (Cl. Tr. p. 5). On April 17, 1965, at about 11:30 p.m. while driving down Washington Boulevard in the City of Los Angeles, he encountered a young female Negro, who called to him, "Do you want a date?" She indicated he should drive further westbound and park the car. The officer testified that he drove to 5204 West Washington where he let his partner out of the car and returned to meet the girl. The officer and the girl discussed an act of prostitution. They then drove in his car to a hotel at approximately 5126 West Washington Boulevard. The officer declined to enter the hotel. A second young Negro female approached the car and the two girls discussed the matter. It was agreed that the first girl would engage in an act of prostitution in the car, with the stipulation that the second girl would follow in her car as a lookout.

(Cl. Tr. pp.6-7).

The second girl left and returned shortly thereafter in a 1956 Pontiac, whereupon the two cars proceeded westbound on Washington Boulevard to the location where the second officer was waiting. Upon arriving at the location the two girls were arrested for prostitution. (Cl. Tr. p. 8).

The officer testified that he and his partner then observed appellant lying on the back seat of the Pontiac. He was ordered out of the car. (Cl. Tr. p. 8). The officer stated he thought appellant was in a position to rob him had he driven to the alley where he had agreed to go with the girls. (Cl. Tr. p. 9).

The officer conducted a cursory search of appellant to determine if he was armed. During the search he discovered an object in appellant's left pants pocket that felt like a cellophane package containing a pill or capsule. He asked appellant what it was and appellant stated, "Nerve pills." (Cl. Tr. p. 9). Appellant was thereupon advised of his constitutional rights to counsel and his right to remain silent. (Cl. Tr. p. 12). Appellant then stated he had no prescription for these pills. The officer removed the package from appellant's pocket and found

numerous pink pills that appeared to be Seconal. (Cl. Tr. pp. 12-13). Objection to this testimony by counsel for appellant was overruled by the court. (Cl. Tr. pp. 14-16).

Appellant was then placed under arrest for possession of dangerous drugs and handcuffs placed on him. A second search of appellant's person was conducted, and the officer found a paper wrapped cigarette, which was marked as People's Exhibit No. 1 by the court. Appellant stated to the officer that the cigarette was marihuana. He admitted having it in his pocket and stated he had obtained it from a friend for 50 cents. (Cl. Tr. pp. 16-18).

Appellant testified in his own behalf and stated he had been asleep in the car at the time the officers found him. (Rep. Tr. p. 6). He further stated he had no knowledge of the activity that the girls were engaged in and that he did not know the second girl. (Rep. Tr. p. 7). Appellant testified he was taken from the car, handcuffed and searched twice, and that he had no knowledge as to how the marihuana cigarette got into his pocket. (Rep. Tr. pp. 7-8). He further denied making any statements to the police. (Rep. Tr. p. 10).

SUMMARY OF APPELLEE'S ARGUMENT

I. The evidence and statements received against petitioner were not the product of an unlawful search and seizure.

II. The Miranda principles do not apply to petitioner's case.

III. Petitioner was not deprived of any constitutional rights by the tactic adopted by his trial counsel of submitting the case on the transcript of the preliminary examination.

ARGUMENT

I

THE EVIDENCE AND STATEMENTS RECEIVED AGAINST PETITIONER WERE NOT THE PRODUCT OF AN UNLAWFUL SEARCH AND SEIZURE.

Little can be added to the incisive and persuasive analysis of this issue found in the opinion of the California Court of Appeal. The pertinent state authorities are collected therein. Also, we are satisfied that little can be added to the argument contained in the Points and Authorities submitted to the District Court on this issue. Accordingly, we incorporate by reference the opinion of the Court of Appeal and the

text following the argument heading I in the Points and Authorities as our brief herein (CT 35-37; 39a-391). In addition, however, we add the following paragraphs treating further pertinent authorities.

We have taken the position that the seizure of the evidence from petitioner is justified on each of two separate grounds: (1) there was probable cause to arrest him for complicity in the prostitution offenses, and (2) there was sufficient suspicion to justify his momentary detention for investigation and, further, the circumstances justified the officers in conducting the "pat search" or "frisk" for their own safety which resulted in the discovery of the Seconal pills and the marijuana cigarette. Further comment on the second ground is in order.

As noted in appellee's return (CT 36), the United States Supreme Court has granted certiorari in three cases involving the "stop and frisk" issue (CT 36). It is noteworthy that pending a definitive ruling by the high court in these cases, the highest courts of New York and New Jersey have recently confirmed the "stop and frisk" doctrine. In State v. Dilley, 231 A.2d 353 (N.J. 1967), the Supreme Court of New Jersey in an instructive opinion which collects the pertinent decisions

confirmed that in its view both the temporary-detention-for-investigation doctrine and the superficial search or "frisk" doctrine were constitutionally permissible under the Fourth Amendment.

The Court of Appeals of New York has gone even further under that state's statutory "stop and frisk" law. Thus, New York's "frisk" law allowed only the patting of the exterior of a suspect's clothing. Nevertheless, the court held that where the arresting officer received information from an anonymous informer that a person matching the description of the defendant was carrying a pistol in his left hand jacket pocket, he was not required to make a preparatory frisk but was justified in making an immediate search for the weapon. This action was justified on the ground that to require a "pat" search would gravely jeopardize the officer's personal safety as well as that of the public. People v. Taggart, 20 N.Y.2d 335, 229 N.E.2d 581, 283 N.Y.Supp.2d 1 (1967).

It is plain that the essential prerequisite for a "frisk" search is the existence of circumstances indicating the need for the officer to take steps for his own personal safety or that of others in the immediate vicinity. Manifestly, such circumstances

existed in this case. As noted, the arresting officer testified that he believed petitioner was hidden in the prostitute's car for the purpose of committing robbery (CT 39d).

In an analogous situation, this Court and others have concluded that the safety of officers will justify steps which would not otherwise be warranted. This Court approved the forcible entry by F.B.I. agents into an apartment without first announcing their authority and purpose as required by statute where to do so would have created a substantial peril to the officers. Gilbert v. United States, 366 F.2d 923, 931-32 (9th Cir. 1966). The rationale is equally applicable to this case.

Appellee respectfully submits that there is no constitutional infirmity in petitioner's arrest and that the evidence seized and statements obtained were properly admitted in evidence.

II

THE MIRANDA PRINCIPLES DO NOT APPLY TO PETITIONER'S CASE.

During the "pat" search of appellant after he was asked to step out of the car, the officer felt an object in his left pants pocket which he believed to be pills or capsules. He asked petitioner what this

object was and petitioner replied, "Nerve pills." The officer then immediately advised him that he had a right to an attorney, that he did not have to say anything, and that anything he did say could be used in the future against him (RT 39e). Following this admonition, petitioner made incriminating statements. He contends that the admonition was insufficient and that the statements were improperly received in evidence against him.

Petitioner is not in a position to invoke the rules announced in Miranda v. Arizona, 384 U.S. 436 (1966). Petitioner's trial concluded and judgment was entered on July 30, 1965 (RT 40). The Miranda decision was announced on June 13, 1966. In Johnson v. New Jersey, 384 U.S. 719 (1966), the Supreme Court declared that the rules of Miranda were to have prospective application only. Accordingly, those rules have no application to appellant's case. See also, Frias v. Wilson, 373 F.2d 61 (9th Cir. 1967); Smith v. Wilson, 373 F.2d 504 (9th Cir. 1967).

III

PETITIONER WAS NOT DEPRIVED OF ANY CONSTITUTIONAL RIGHTS BY THE TACTIC ADOPTED BY HIS TRIAL COUNSEL OF SUBMITTING THE CASE ON THE TRANSCRIPT OF THE PRELIMINARY EXAMINATION.

In his petition, appellant alleged that his

trial counsel was incompetent because he advised him to submit the case to the superior court on the transcripts of the preliminary hearing. He asserts that "it is obvious that both of his counsel's [sic] appointed by the court were incompetent and of no help, other than to be the one to deliver up to the Judge, the Lamb, for the Sacrifice, ..." (RT 23). The record refutes this contention.

The reporter's transcript indicates that appellant was thoroughly interrogated by the district attorney concerning his understanding of the waiver of his right to a jury trial. Thereafter, defense counsel stipulated that the prosecution's case could go in on the transcript of the preliminary hearing subject to any objections. After the court read the transcript, the prosecution rested. Defense counsel then vigorously objected to the introduction of the physical evidence on the ground that the "pat down" search or "frisk" was unlawful. After the objection was overruled, appellant took the stand and testified in his own behalf concerning the circumstances of the arrest and search (CT 39g-39h). At no time during the entire proceeding did appellant assert or even hint of any objection to the procedure followed.

Relying on Brookhart v. Janis, 384 U.S. 1 (1966), appellant asserts that the procedure adopted by his counsel was tantamount to the entry of a plea of guilty by the attorney. In Brookhart, the court characterized the proceeding described as a "prima facie trial" as "the equivalent of a guilty plea." Id. at 7. The court summarized its holding as follows, "Our question therefore narrows down to whether counsel has power to enter a plea which is inconsistent with his client's express desire and thereby waive his client's constitutional right to plead not guilty and have a trial in which he can confront and cross-examine the witnesses against him. We hold that the constitutional rights of a defendant cannot be waived by his counsel under such circumstances." Ibid. (Emphasis added). On its facts, Brookhart is plainly distinguishable from the present case. Here there is no indication at trial that appellant disagreed with the course proposed and taken by his counsel.

It is common knowledge that where an attorney believes he has an arguable case of an unlawful search and seizure he may prefer to have that question decided on the usually sketchy evidence adduced at a preliminary hearing rather than allow the prosecution to buttress its case at a full trial. Many other considerations may

also be behind such a decision. See CEB, California Criminal Law Practice, § 8.75 (1964). Here, counsel vigorously pursued his objection to the introduction of the marijuana cigarette and placed appellant on the stand to testify to his version of the arrest and search. This was unquestionably a tactical decision which it was within the competence of the attorney to make.

In this Circuit, it is settled that an attorney can waive the right to confront and cross-examine witnesses on behalf of a client where it is done as a legitimate strategy of defense. And manifestly, such a decision does not establish that the attorney was incompetent. See Wilson v. Gray, 245 F.2d 282 (9th Cir. 1965); Silva v. Klinger, 355 F.2d 657, 658 (9th Cir. 1966); Butler v. Wilson, 365 F.2d 308, 310 (9th Cir. 1966). Indeed, this Court has specifically held that the Brookhart principle does not apply under circumstances such as appear in this case. Symons v. Klinger, 372 F.2d 47, 49-50 (9th Cir. 1967).

Appellee therefore submits that the District Court properly rejected appellant's claim that he was denied constitutional rights by the procedure of submitting the case on the transcript of the preliminary hearing.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the order of the District Court denying appellant's petition for a writ of habeas corpus should be affirmed.

DATED: December 18, 1967

THOMAS C. LYNCH, Attorney General
of the State of California

DERALD E. GRANBERG
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CERTIFICATE OF COUNSEL

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that in my opinion this brief is in full compliance with these rules.

DATED: San Francisco, California

December 18, 1967

MICHAEL J. PHELAN
Deputy Attorney General
of the State of California

No. 22272

In the

United States Court of Appeals

For the Ninth Circuit

KAISER STEEL CORPORATION, *Appellant,*	
vs.	
UNITED STATES OF AMERICA, *Appellee.*	

Appeal from the Judgment of the United States District Court for the Northern District of California.

Brief for Appellant

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No. 22272

In the

United States Court of Appeals

For the Ninth Circuit

Kaiser Steel Corporation, *Appellant,*	
vs.	
United States of America, *Appellee.*	

Appeal from the Judgment of the United States District Court for the Northern District of California.

Brief for Appellant

A. JURISDICTIONAL STATEMENT

This is an action against the United States for a refund of Federal income taxes. Jurisdiction is based on Section 1346(a)(1), Title 28, U.S. Code. (Para. 1, Pre-Trial Order, R. 28).

B. STATEMENT OF THE CASE

This is an action by Kaiser Steel Corporation (hereafter called "Kaiser") for a refund of Federal corporation income taxes. During the period involved Kaiser filed its tax returns on a fiscal year basis, and the tax years in question are the fiscal years ending June 30, 1949 and June 30, 1950.

The case turns upon the proper "representative market price" to be used in computing depletion with respect to coking coal mined by Kaiser from properties at Sunnyside, Utah, and iron ore mined by Kaiser from its mines in California. This coking coal and iron ore was used by Kaiser at its steel mill in Fontana, California, and no relevant sales were made of it by Kaiser.

A large volume of factual data was put into evidence at the trial. By and large the essential facts are uncontroverted. Therefore, it will not be necessary for the Court to weigh conflicting evidence. However, the parties differ sharply as to the inferences and conclusions, both factual and legal, to be drawn from the underlying undisputed data.

At the close of the trial the District Court, in addition to requesting briefs from each party, asked each party to submit at the same time its proposed findings of fact and conclusions of law. The findings and conclusions proposed by Kaiser appear at pages 85 to 118, inclusive, of the Transcript of Record[1] while the findings and conclusions proposed by the defendant United States (hereafter called the "Government") appear at pages 119 to 144, inclusive. The District Court adopted as its findings and conclusions (R. 31-55), the findings and conclusions proposed by the Government virtually in verbatim form.

No written or oral opinion was prepared by the District Court. The judgment as entered simply holds that Kaiser is entitled to take nothing. (Record, p. 56).

Kaiser then filed motions to amend the findings of fact, to make additional findings of fact, to alter or amend judg-

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1. For brevity the Clerk's Transcript of Record (one volume) will hereafter be referred to as the "Record" or "R.", while the reporter's transcript of the trial proceedings (ten volumes) will be referred to as the "Transcript" or "Tr.".

ment and for a new trial. (Record, pp. 57-80). These motions and the memorandum in support thereof clearly set forth the significant errors in the findings, conclusions and judgment. The Court simply denied these motions without opinion. (Record, p. 82). Consequently, in the preparation of this appeal, it has been necessary for Kaiser to approach the problem *de novo* since we have no guidance from any opinion or decision of the Trial Court.

No help is afforded in trying to understand the basic rationale of the decision by the conclusions of law. On the contrary, many of the principles enunciated by those conclusions undermine the findings of fact and decision of the Court. For example, in Conclusion of Law No. 6 (R. 52), it is stated that, "Physical, chemical or geological differences have importance only if they are recognized in commercial competition." The evidence is uncontroverted that differences of percentage of ash content in coking coal are specifically recognized in commercial competition and price adjustments are made on account thereof. The decision in determining a representative market price pays no attention to this express commercial practice and its effect on price. In Conclusion of Law No. 7 (R. 52), the Court states that a representative market price "is provable only by actual sales transactions entered into between buyer and seller after arm's-length negotiations." The evidence shows that none of the sales of coking coal by Utah Fuel Company (which the Court used in part for the purpose of establishing a representative market price for Kaiser's coals) were the result of any *arm's-length* negotiations between buyer and seller—rather they were the result of distressed economic conditions which forced Utah Fuel Company to make these sales at whatever price it could get if it was to keep this particular mine open. Conclusion

of Law No. 7 (R. 53) states further that "prices paid by buyers in unrelated geographical markets . . . have no bearing" in determining a representative market price. The evidence shows that all of the Utah Construction Company sales of iron ore (used by the Court to establish a representative market price for Kaiser's iron ore), other than the sales made to Kaiser Steel and the sales made for export at Long Beach, were in a geographical market unrelated to Kaiser's California iron ore mines.

Kaiser is an integrated manufacturer of iron and steel products. Its principal manufacturing facilities are located near Fontana in San Bernardino County, California. For use in its steel making process Kaiser produces coke by processing coking coal through coking ovens. This coke, together with iron ore and other materials, is charged into a blast furnace from which iron is obtained. (Finding[2] No. 12, R. 33). In making this coke Kaiser used coal it mined from properties located near Sunnyside, Utah, together with some purchased coal. (Finding No. 13, R. 33).

The iron ore used by Kaiser in its blast furnaces was mined by Kaiser in the first year from its Vulcan mine in San Bernardino County, California, and in both years from its Eagle Mountain mine in Riverside County, California. Also some iron ore was purchased for the reasons and under the circumstances hereafter described. (Finding No. 14, R. 33-34).

The iron ore produced by Kaiser was not sold by it but was wholly consumed and utilized in its own operations. The same thing is true as to coking coal which it mined (except to a minor and irrelevant extent).

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2. Findings of the District Court are referred to simply as "Finding".

Under the applicable Internal Revenue Code,[3] Kaiser is entitled to a deduction for depletion of these minerals computed as a percentage of the "gross income from mining". The statute does not define gross income from mining. The treasury regulations[4] in effect at the time in question provide that if the taxpayer sells the mineral product in the immediate vicinity of the mine "gross income" means the amount for which such product was sold, but if the product is processed before sale (as was the case here) "gross income" means the "representative market or field price (as of the date of sale) of a mineral product of like kind and grade".

Since, as previously indicated, no relevant sales of Kaiser's mineral products were made, a "representative market or field price" for such products must be determined in order to compute the proper depletion deduction. That determination is the issue of this case.

1. Iron Ore

A principal ingredient used by all iron and steel companies in a blast furnace is iron ore. The product produced from the blast furnace is pig iron. The principal factor used in comparing and pricing iron ores is the amount of iron contained in the ore (the so-called Fe content). Other factors are the amount of Sulphur (S), Phosphorous (P), Silica (SiO_2) and the moisture content of the ore, i.e., whether it is wet or dry. (Finding No. 23, R. 37). Iron ore becomes more valuable as the iron (Fe) content increases. (Finding No. 24, R. 38). Sulphur and phosphorous are deleterious and must be removed from the ore by various means. (Finding No. 25, R. 38). Ore used in blast furnaces

3. Section 114(b)(4), 1939 I.R.C., Appendix B hereto.

4. Regs. 111, Sec. 29.23(m)-1, Appendix C hereto.

must be crushed and screened to size and must not have too many "fines". (Finding No. 29, R. 39).

Steel companies also use open-hearth grade ore in their open-hearth furnaces. This ore has special characteristics to adapt it to that use. It must be in a lump form in order to sink through the molten bath in the open-hearth. It must be hard dense ore approximately 1½ or 2 inches to 10 inches in size, with high iron and low sulphur and phosphorous content. (Powell, Tr. 733-735). This type of ore is not the commodity which is involved in this case. We are concerned only with blast furnace grade ore.

During the time involved there were only four *producers* of blast furnace grade iron ore in the Western United States—Columbia Iron Mining Company, Colorado Fuel and Iron Corporation, Utah Construction Company, and Kaiser. The only *consumers* of blast furnance grade iron ore in the western United States were Colorado Fuel and Iron Corporation, Geneva Steel Company and Kaiser. (Admissions of Fact, No. 2, R. 23). There were no published prices for iron ore in the western United States. (Admissions of Fact, No. 1, R. 23).

Colorado Fuel and Iron Corporation produced all of its blast furnace grade iron ore from its own mines in Utah and Wyoming and made no sales of such ore. (Exhibit 34, p. 15, lines 10-25). Geneva Steel Company acquired its iron ore (except for a single emergency purchase to be discussed later) from Columbia Iron Mining Company, which produced for and sold ore to no other person or entity. Both Columbia Iron Mining Company and Geneva Steel Company were wholly-owned subsidiaries of United States Steel Corporation. (Exhibit 35, p. 21, lines 1-6). Ore was transferred between the two subsidiary companies at a price which was determined without reference to what the ore might have been purchased for from independent sources.

(Exhibit 35, p. 24, lines 8-15). The record contains no evidence of any transfer price used by either Colorado Fuel and Iron Corporation or Geneva Steel Company for these inter-company transfers.

Kaiser produced its blast furnace ore from its Eagle Mountain and Vulcan mines and procured some blast furnace and open hearth ore under contract with Utah Construction Company. The amounts (in net tons of 2,000 lbs.) were as follows (Findings 15 and 21, R. 34 and 36).

	Year ending 6/30/49	Year ending 6/30/50
Eagle Mountain Mine (owned)	276,655	835,215
Vulcan Mine (owned)	167,970	—
Utah Construction Co. (Blast Furance and Open Hearth)	146,501	228,924

Utah Construction Company was in the construction business. In 1941 it obtained a contract to mine iron ore for Colorado Fuel and Iron Corporation from iron mines owned by that corporation in Utah. It was paid on the basis of a price per ton for mining and a price per yard for stripping. (Christensen, Tr. 489, line 7 to 490, line 8). In 1944, an individual named Senter Walker, who held some iron ore deposits in Utah, entered into a similar mining contract with Utah Construction Company for it to perform similar operations on his property. (Christensen, Tr. 490, lines 14-21; Tr. 493, line 17 to 494, line 9). In 1946, operating difficulties developed with Walker which threatened to close down his mine. Since Utah Construction Company had by this time built up an investment in its construction mining equipment, and was interested in continuing the mining contract from which it had been deriving a satisfactory profit from a contractor's point of view, it took over Walker's operation. (Christensen, Tr. 496, lines 1-14).

Kaiser procured iron ore from the Utah source, first under contract with Walker and later under contract with Utah Construction. These were interim contracts intended to continue only until such time as Kaiser's Eagle Mountain property would become fully operative. (Admissions of Fact No. 7, R. 24). All parties were aware that purchases by Kaiser were diminishing and that when Kaiser's Eagle Mountain facility went into operation, there would be no further purchases of blast furnace grade iron ore by it from Utah sources. The Eagle Mountain mine went into full production in 1950 and purchases of blast furnace grade ore from Utah ceased. (Christensen, Tr. 530; Powell, Tr. 732-3). Utah was fully aware that Kaiser would nevertheless continue to purchase open-hearth grade ore for use in its open-hearth grade furnaces from some source and it was interested in preserving this market. The former president of Utah Construction Company, who was a witness at the trial, testified without contradiction that because of these factors the contract price to Kaiser was set in 1946 when Utah took over by simply continuing the previous price in the Walker contract *without regard to the value of the ore* but merely to recover operating costs and investment plus the contractor's profit which it had been making on its mining and stripping operations. (Christensen, Tr. 499, line 20; Tr. 502, lines 13-17; Tr. 507, lines 10-19).

The total iron ore sales of Utah Construction Company for the years in question, including the ore produced under the contract with Kaiser, appear in Finding No. 22 (R. 36-37). The only sales involving any material tonnage of blast furnace grade ore, other than those to Kaiser or one of its affiliated companies, were certain sales for export to Japan at Long Beach, California and a sale to Geneva Steel

Company in 1950. The sale to Geneva Steel Company which arose out of temporary operational difficulties at the Geneva Steel facility (Admissions of Fact No. 4, R. 23), was a stock pile of fine and soft ore which had been accumulated as a residue from other sales of regular grade ore. The price at which this transaction took place reflected these facts. (Christensen, Tr. 531, line 6 to 532, line 5). The export to Japan was the first and only shipment of iron ore to the Japanese from the United States during the period 1939 to 1950. The price reflected the controlled situation of the Japanese economy during the immediate post-war period.

On the basis of the foregoing evidence, which was essentially undisputed, the District Court concluded that the "representative" price to be established at Kaiser's mines in California for the ore which Kaiser mined and used was the same as a mine price at the Utah Construction Company mine in Utah. It was computed on a weighted average of *all* the Utah Construction Company transactions and developed a price of \$2.29 for 1949 and \$2.03 for 1950 (Finding 35, R. 41).

The uncontroverted evidence shows, however, that these Utah transactions are not of the kind or character which can establish a "representative market or field price," because they arose out of and were subject to special reasons and circumstances and did not truly reflect a "representative" market or "market price" as between independent producers and consumers of iron ore. Therefore, it is necessary to look elsewhere for a "representative market or field price of [iron ore] of a like kind or grade." The only place in the United States where a free exchange of transactions in iron ore regularly takes place is at the Lower Great Lakes Ports, and reported prices for these

transactions are available from standard reference sources. (Exhibit SS). Prices established at this market are used in the West for valuing ore. The evidence established that the iron ore produced by Kaiser was at least the equivalent in quality of Mesabi non-Bessemer ore sold in that market. (Pardee, Tr. 583, line 18 to 584, line 13). Therefore, Kaiser contends that the representative market or field price for ore it mined should be on the same basis as the Lower Lake Port ore, making appropriate adjustment for the Fe content. (The ore price thus determined is to be a price at Kaiser's Fontana mill which is the market. This price would be reduced by the freight from Kaiser's mines to Fontana in order to determine the price at Kaiser's mines.)

Expert economic testimony (again without contradiction in any significant respect) demonstrated that Lower Lake Ports were not an unrelated market. There was a sizeable movement of iron and steel products into Kaiser's markets in the western United States from iron and steel producers in the eastern United States. There was competition in these products between eastern producers and Kaiser. (Howard, Tr. 829, lines 1-7). The price for finished steel products produced in the East has a direct relationship to the Lower Lake Port price for iron ore which is used in their manufacture. (Exhibits 7 and 8). Since the finished products were in competition and therefore the prices of the finished products were interrelated, and since the prices of eastern finished products are related to eastern ore prices, a price for Kaiser's western ore can be reliably developed from the prices for western finished products. The price as so developed substantiates the soundness of the position that the price for Mesabi non-Bessemer ore at the Lower Lake Ports is "a representative market or field price for a mineral product of like kind and grade" which should

be used to establish a price for Kaiser's ore for depletion purposes. As shown by Appendix F attached, the proper representative market prices should be \$4.159 and \$4.472 for 1949 and \$5.132 for 1950 instead of the \$2.29 and \$2.03 found by the Court.

Even assuming, arguendo, that ore sales by Utah Construction Company would be a starting point for determining the price for Kaiser's iron ore for depletion purposes, the District Court made two gross errors in fixing a market price, which are extremely prejudicial. *First,* it improperly used sales of Utah Construction Company which in any view are not representative transactions. The District Court, as an example, considered as "representative" and used the very large spot sale to Geneva Steel of low grade "fine" ore which is clearly a different mineral product and was sold under distress conditions. *Second,* the District Court in fixing a price gave no consideration to the effect on price of substantial freight differentials which arise by reason of the fact that the Kaiser mines are closer to the only relevant market than those of Utah Construction Company. The Court equated the Utah Construction Company mine price *at its Utah mine* with the Kaiser mine price at Kaiser's California mines. The only market in which Kaiser ore could have competed were the sales to Kaiser itself and the sales by Utah Construction Company for export to Japan. In each instance the Kaiser mine was much closer to the point where the sale transaction (i.e., Kaiser's plant at Fontana, California, or the point of shipment to Japan at Long Beach, California) occurred and the representative market price was established, so that the mine price (sale price less freight to point of sale) at Kaiser's mine would in all events exceed the price at the Utah mine. *Third,* it was only the price established by the

export sale which had any of the indicia of being the "result of competitive conditions" as opposed to the "peculiar economic conditions" existing in connection with all of the other sales by Utah Construction Company.

The effect of these errors on the "representative market price" determined by the Court is extremely significant. Using the export sales the representative market price at the Kaiser mine should properly have been $5.25, $5.90 and $4.66 for each of these respective shipments, as compared with $2.29 and $2.03 "representative price" set forth in Finding 35 (R. 41).

2. Coking Coal

The other important ingredient used in producing iron in a blast furnace is metallurgical coke. In making coke, Kaiser used high volatile coal it mined from properties in Utah together with low volatile coal that it purchased from Oklahoma and Arkansas. The coal mining properties were located at Sunnyside, Utah. (Finding No. 13, R. 33).

In comparing coking coals from different sources, a number of factors are considered. These include the amount of fixed carbon, volatile matter (gases), sulphur and ash that are contained in the coal, and the plasticity of the coal. (Finding No. 53, R. 45).

The most important factor in coking coal is its fixed carbon. It is the fixed carbon in the coal that iron manufacturers are purchasing when they buy coking coal for it provides the fuel in the blast furnace. (Finding No. 54, R. 45). The testimony is uncontradicted that the market price always reflects differing fixed carbon contents. As the carbon content increases the price increases.

Ash is the term used in the coking coal industry to describe the undesirable physical elements in coal [other

than volatile matter, sulphur, and phosphorous]. Ash in the form of "free impurity" (rock or shale) may be removed by washing the coal before it is processed into coke. Ash not so removed and the "inherent ash" must be removed in the blast furnace. Both of these processes increase a manufacturer's cost of production. (Finding No. 58, R. 46). As the ash in coal purchased increases, the amount of fixed carbon decreases. The testimony is uncontradicted that the market price is always adjusted for and reflects differing ash contents and that these prices have varied from 10¢ to 40¢ per point of ash per ton.

Plasticity is a distinguishing characteristic of coking coal. When coking coal is processed in a coke oven, one of its constituent parts, vitrain, tends to melt and become a viscous liquid as the coal is heated. As the coke cools, the vitrain hardens to form a binder for the fixed carbon in the coke. Plasticity gives the coke physical strength so that it does not pulverize or break down in the blast furnace. (Finding No. 67, R. 49). The testimony is uncontradicted that this characteristic is not reflected in prices for different coking coals.

High volatile coking coal (having a relatively high portion of volatile matter) when used alone produces a coke that is physically weak and has the undesirable tendency of pulverizing in a blast furnace. (Finding No. 60, R. 46-47). Low volatile coking coal (having a relatively low portion of volatile matter) cannot be used alone because it tends to swell and damage the ovens. (Finding No. 61, R. 47). Therefore, the uniform practice of western steel producers in making coke was to blend coking coals of various volatility to arrive at a coke with optimum strength at the most economical cost. All of the western steel producers purchased substantial tonnages of low volatile coking coal

from mines in the Arkansas-Oklahoma region of the United States. (Finding No. 62, R. 47).

The coking coal mined by Kaiser came from a mine near Sunnyside, Utah, known as the Sunnyside No. 2 Mine, which Kaiser leased from Utah Fuel Company in 1942 and purchased in early 1950 (Finding No. 48, R. 44). The production by Kaiser for its own use during the period in question (in net tons of 2,000 lbs.) was as follows:

Fiscal year ended June 30, 1949—416,615
Fiscal year ended June 30, 1950—591,568

(Finding No. 36, R. 41). In addition, Kaiser disposed of nominal and irrelevant amounts of Sunnyside coal for non-coking purposes. 25,260 net tons was sold in the fiscal year ending June 30, 1949, and 28,340 net tons in the fiscal year ending June 30, 1950.[5] (Finding No. 41, R. 42-43).

All of these coal sales by Kaiser were transfers at cost or accommodations arising out of some special circumstance. Transfers to Geneva Steel Company resulted from the fact that its mine was adjacent to Kaiser's mine and the companies made accommodation transfers of coal for testing and assisted each other in the event of labor stoppages. (Admissions of Fact No. 23, 24 and 25, R. 25-26). The transactions with Utah Fuel Company and its customers were made partly as an accommodation to Utah Fuel, Kaiser's lessor, and partly to balance the fact that both companies used the same washer and it was not always feasible to allocate the washed coal precisely. (Heers, Tr.

5. Transfers of coal between Kaiser and Kaiser-Frazer, a related entity, were disregarded by the District Court as not being sales *because they were made at cost*, and are disregarded here. (Finding No. 41, R. 42). No reason is given by the District Court as to why other sales also made at cost to Columbia Geneva Steel, Permanente Metals (a related entity) and Denver & Rio Grande Western Railway are included in its computation of price.

110, lines 3-7; Tr. 116, lines 18-21; Heiner, Tr. 335, line 20 to 336, line 8). The other transactions were mainly "sales" to railroads arising out of cars lost in transit. (Heers, Tr. 97, lines 14-17).

Utah Fuel Company, Kaiser's lessor, owned and operated mines producing coal of a non-coking quality. It also owned a mine known as Sunnyside No. 1, which was adjacent to Sunnyside No. 2 and produced coal of the same coking quality as Sunnyside No. 2. To the extent it could find buyers, it made sales of the coal from Sunnyside No. 1 for domestic and commercial uses only, in the tax years in question (Heiner, Tr. 328-330). This coal was not desirable or salable for the domestic or commercial trade and all such sales were made on a distress basis (Heiner, Tr. 341, lines 22-24). This was because the coking characteristics of the coal were entirely undesirable for commercial or domestic use. This mine had been operated at a loss since 1929 (Heiner, Tr. 331, lines 8-11). The operation was, however, continued even though on a losing basis in the hope that the property would eventually fit into the expansion of the western steel industry and its market for coking coal (Heiner, Tr. 373, lines 19-22).

During the time in question one producer of iron and steel in the western United States, Colorado Fuel and Iron Corporation, did purchase a substantial volume of its high volatile coking coal on the open market. (Finding No. 64, R. 47). Most of this coal was acquired from St. Louis, Rocky Mountain & Pacific Company of Raton, New Mexico, sometimes called "Raton Coal Co.". (Finding No. 65, R. 48). In addition, all the iron and steel producers purchased substantial tonnages of low volatile coking coal from the mines in the Arkansas-Oklahoma region for coking purposes. (Finding No. 62, R. 47).

In determining a "representative" market price for the coking coal mined by Kaiser, the District Court looked only to the distress sales by Utah Fuel Company for non-coking purposes plus the minor volume of special circumstance sales by Kaiser. The District Court said that the sales by Raton Coal Co. to Colorado Fuel and Iron Corporation "confirm" the sale prices obtained by Utah Fuel Company. (Finding No. 71, R. 50). However, the District Court did not, in fact, utilize these prices in finding the price for Kaiser's coal despite the fact that the Court also found that the Raton Mesa coal and the Sunnyside coal "competed directly in the market place . . ." (Finding No. 70, R. 49).

The sales by Kaiser and by Utah cannot be used to find a representative market price. They were made at or less than cost, under distress conditions and not in any competitive market. The open market sales in substantial volume by Raton Coal Co. to Colorado Fuel and Iron Corporation of coking coal either alone or in conjunction with the substantial sales of Oklahoma-Arkansas coking coal to the iron and steel producers (which latter sales were also totally ignored by the District Court) should have been used as the basis for determining the price of coking coal mined by Kaiser. In determining a representative market price from the Raton sales, adjustments must also be made for the lower ash characteristics of Kaiser's coal[6] since the uncontradicted testimony established that these factors are always considered in pricing coal and "recognized in commercial competition". (Heers, Tr. 87, line 25; Keenan, Tr. 267, line 11; and see Finding No. 58, R. 46).

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6. Compare the ash of 7.1% and 6.8% in Kaiser's coking coal (Finding No. 59, R. 46) with the 11.8% and 12.3% in the Raton Coal Co. coal sold to Colorado Fuel and Iron Corporation. (Finding No. 66, R. 49).

C. SPECIFICATION OF ERRORS

The principal errors relied upon by Kaiser are, *with respect to iron ore,* (1) The failure of the District Court to find that there was a market for iron ore at the Lower Great Lake Ports in the United States during the tax years in issue at which a representative market price was established applicable to iron ore produced in the western United States and in failing to consider or utilize such price in determining a representative market or field price for the iron ore mined by Kaiser. (2) The District Court's finding that transfers and dispositions of and the mine prices received by Utah Construction Company for iron ore transferred or disposed of by it established a representative market or field price for iron ore mined by Kaiser. (3) The District Court's failure to find that, if transfers or dispositions of iron ore by Utah Construction Company are to be used to establish a representative market or field price for iron ore, only the prices received for export sales to Japan should be considered for such purpose. (4) The District Court's failure to find that, if transfers or dispositions of iron ore by Utah Construction Company are to be used to establish a representative market or field price for iron ore, freight differentials between the point of sale or consumption and the point of production must be taken into account in determining representative market or field prices for iron ore at Kaiser's mine.

With respect to coking coal, the District Court erred (1) In finding that transfers or dispositions of and the amounts received by Utah Fuel Company for Sunnyside No. 1 coal established a representative market or field price for Kaiser's coking coal. (2) In finding that transfers and dispositions of and the amounts received by Kaiser for Sunnyside No. 2 coal established a representative market or field

price for Kaiser's coking coal. (3) In failing to use sales of Raton Coal Co. coal for coking purposes, as adjusted for washing costs and ash content, in determining a representative market or field price for Kaiser's coking coal. (4) In failing to use sales of Oklahoma-Arkansas coking coal in determining a representative market or field price for Kaiser's coking coal. (5) In failing to consider, when establishing a representative market or field price for Kaiser's coking coal, recognized price adjustments made in the market for ash content and washing loss. (6) In finding that the element of plasticity is or should be given any consideration in the determination of a representative market or field price.

D. ARGUMENT

The fundamental problem both with respect to coking coal and with respect to iron ore is to find the "representative market price" to be used in computing Kaiser's "gross income from mining". When this is determined the computation of the deduction for depletion amounts to nothing more than the application of a mathematical percentage to the gross income figure. The difficulty arises because Kaiser as an integrated producer utilizes its mining production in making a final product. The mineral products are not sold in the open market. It is therefore necessary, according to the regulations, to determine a "representative market or field price of a mineral product of like kind and grade". The prices to be used must be for materials of like kind and grade and these prices must be "representative". In the view of the Supreme Court this representative price should be one which the mineral product would command if the taxpayer's mining operations were conducted as a separate and independent business entity. *U. S. v. Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960).

This leads to the basic difference in approach in this case. The position argued by the Government, and seemingly adopted in toto by the District Court, is that any price, at any time, and under any circumstances is sufficient to establish a "representative market price". The mere fact that the transaction occurred at all seems to make the price realized "representative" of the "market" in which that transaction occurred.

Kaiser believes that such an approach is contrary to the intent of the law and regulations and is completely unrealistic. We say that in determining the hypothetical price at which the mineral produced would have been sold by an independent miner to an independent steel producer, consideration must be given to all other transactions in the mineral products involved. This consideration must however include an examination of all the facts and circumstances surrounding the transactions under consideration to determine if the prices established in such transactions are, in fact, truly "representative" of the prices which would obtain in an arm's length sale between an independent miner and an independent manufacturer. If, as here, the evidence indicates that special circumstances or factors affected the reliability of the transactions, then appropriate corrective adjustments must be made or the transactions must be discarded entirely and other reliable evidence of representative market prices must be located.

Under the regulations the search is for a representative market or field price. Representative market price is a question of fact. *Ames v. U. S.,* 330 F.2d 770, 773 (9th Cir. 1964). Since the question is one of fact, all of the facts surrounding a price arrived at in a particular transaction must be examined to determine if that price is representative. The rule is not that *any* price is to be used, but that only repre-

sentative prices are used. As the Court observed in *U. S. v. Henderson Clay Products,* 324 F.2d 7 (5th Cir. 1963), at page 15:

> "The Regulation does not allow the indiscriminate use of any price of a product of like kind and grade, but requires the price to be representative; 'representative' should be interpreted to qualify the entire phrase 'market or field price'."

The facts of a particular transaction may indicate that the transaction is not a representative one, and the prices used in that transaction thus must be excluded from consideration. That is all Kaiser has said in this case.

For example, in the leading case of *U. S. v. Cannelton Sewer Pipe Co.,* supra, the Court found that certain sales of ground and bagged fire clay and shale were too negligible to furnish an appropriate basis for computing depletion. (364 U.S. at 78, fn. 2).

Other cases have recognized that the facts surrounding some sales may make them not representative. In *Carey Salt Company v. U. S.,* 667 CCH Para. 8157 (Ct.Cls. 1966) the issue was the determination of depletion on certain of the taxpayer's rock salt deposits. The taxpayer, in order to discourage two of its competitors from mining rock salt, and because these competitors sold the taxpayer evaporated salt when its demand temporarily exceeded its supply, sold rock salt to the two competitors at a lower price than would have been commanded from ordinary customers. These competitors, in turn, sold the rock salt on the open market in competition with the taxpayer. The Commissioner included these sales of rock salt to competitors in his computation of the average price per ton of rock salt sold during the tax period involved. The Court of Claims held that the Commissioner's approach was erroneous. It noted that the

taxpayer sold rock salt to its competitors at a substantially lower price than could be obtained on the open market, and the competitors then sold the same rock salt to ordinary customers who otherwise might have purchased rock salt from the taxpayer. The competitors could afford the taxpayer's price for rock salt only because it was lower than the market price. The Court observed that constructive income is an attempt to simulate the sales income of a non-integrated miner and concluded that a non-integrated miner would in all probability sell the additional products of his mine on the open market. It held that the Commissioner was in error when he included the special prices obtained from the competitors in the computation of the taxpayer's constructive net income. Here then is a clear recognition of the principle that not every sale which is made is necessarily a representative sale and a demonstration of one type of special economic factor which requires a particular sale to be excluded from consideration.

Another case of similar import is *Gray Knox Marble Company v. U. S.,* 257 F.Supp. 632 (E.D. Tenn. 1966). That case involved the depletion on marble blocks used by the taxpayer in its plant to manufacture finished products. The taxpayer contended that the sales of quarry blocks by it to others, or if not by it to others, then sales by its competitors to others, established a representative market or field price which should be used for depletion. The Government contended that the sales of quarry blocks made by the taxpayer or the other miners were in such small quantities, under the circumstances existing in the case, that they were not truly representative of the value of the marble which the taxpayer processed and sold in manufactured form. The Government also claimed that the sales of marble blocks were marketable at premium prices because job specifications were set by architects for the kind of marble to be

used, and that this put the taxpayer and the other miners in a monopolistic position and enabled them to sell blocks at premium prices. The Court upheld the Government's contention, that the prices at which the marble blocks were sold were not representative prices. Again, we have an example of a Court examining the facts of certain transactions and eliminating such transactions from consideration for the reason that they were not "representative" transactions. In the *Gray Knox* case it so happened that the elimination served the advantage of the Government. The principle, of course, is the same—in determining whether a transaction takes place at a representative price, all of the facts of that transaction must be considered.

If any further proof on this point is required, we need merely look to the regulations which the Commissioner himself proposed on July 13, 1966. 31 F.R. 9506.[7] These proposed regulations state:

> "Sales of ores or minerals of like kind and grade as the taxpayer's will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral *only if such sales are the result of competitive transactions.* For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, *exceptional, nominal, unusual, tie-in, or accommodation sales shall be disregarded.*" (31 F.R. 9508). (Emphasis added.)

One fact which can be of relevance in determining whether a sale is a "representative" sale is the fact of intended use. A good example of this appeared in *North Carolina Granite Corp.*, 43 T.C. 149 (1964). The taxpayer there extracted a certain type of granite which was particularly well suited for feeding to poultry as grit. When sold

7. Appendix E hereto.

for poultry grit, the granite commanded a price of from $8 to $10 per ton. The granite also was suitable for use as road building material, but sales for that purpose brought only $1 to $1.50 per ton. The Commissioner contended that the price to be realized from sales for road building purposes governed for depletion purposes, but this argument was rejected. The Court said that the average prices at which the taxpayer "sold its crushed granite in bulk to road builders were not *representative* of the value of the product to the poultry industry". (43 T.C. at 161, italics added). The Tax Court held that the poultry grit price was to be applied in determining depletion of the material sold for that use.

There are three cases referred to in the District Court's conclusions of law which deal with percentage depletion as applied to coking coal and iron ore. All of these cases arose in the United States District Court for the Northern District of Alabama. One decision was affirmed on appeal by the Court of Appeals for the Fifth Circuit. All were decided by District Judge Seybourn H. Lynne and, except for the narrow point upon which one decision was affirmed by the Court of Appeals, the cases represent the views of a single Federal District Judge. Between the decesion of the first case in the series and the last, even this one Court had occasion to change its opinion as to some of the matters in issue. Be this as it may, there is nothing in any of these cases which is inconsistent with the position adopted by Kaiser in this case.

The first case was *Alabama By-Products Corp. v. Patterson,* 151 F.Supp. 641 (N.D. Ala. 1957). The taxpayer in that case produced a high grade of foundry coke from high quality coking coal which it mined and used in its operation. The taxpayer contended that there was no represent-

ative market or field price for the type of coking coal which it produced, since this coal was of such high quality and had such desirable properties that it was not of "like kind and grade" as any other coal. Since there was, therefore, no representative market or field price for any coal of like kind and grade as this taxpayer's coal, the taxpayer argued that it was entitled to use the "proportionate profits" method of calculating depletion for income tax purposes.

District Judge Lynne rejected this argument and held that all bituminous coal mined in the Birmingham district was of "like kind" and that all bituminous coal having coking properties was of "like grade". Since it appeared there were significant *sales and purchases* in the open market in the Birmingham district by the taxpayer and others of coal used for *coking purposes,* the District Court held that these should be used to ascertain a representative market or field price for such coal. The Court found it unnecessary to determine, and did not determine, what such representative market or field price was. No evidence was introduced nor did the Court make any findings concerning recognized adjustments in price for washing costs, washing losses, fixed carbon or ash content. The taxpayer had rested its entire case upon the proposition that it was entitled to use the proportionate profits method because there was no representative market or field price. Having failed to establish the necessary predicate for use of the proportionate profits method, the taxpayer was afforded no recovery at all.

This holding of Judge Lynne was affirmed upon appeal to the Fifth Circuit Court of Appeals. 258 F.2d 892 (1958), *cert. den.* 358 U.S. 930. The Court of Appeals agreed that all bituminous coal mined and marketed in the Birmingham area having coking properties for commercial usage was

coal of "like kind and grade" to the taxpayer's coal. Since there was evidence of extensive sales of coking coal for coking purposes in the Birmingham area, the Court of Appeals affirmed the finding that the taxpayer had failed to prove the absence of a representative market or field price for coking coal. The Court of Appeals said that because a coking coal could not meet the taxpayer's particular use did not mean that it was of another kind and grade. To this extent only the use test was rejected. The Court of Appeals did not say that ultimate intended use should not be considered in determining whether the price at which a particular transaction took place was a "representative market price". Quite to the contrary the Court noted that there was a distinction of commercial substance between coal of coking and non-coking quality. Further, the Court observed that "*forced* sales owing to perculiar economic conditions", as for example sales made at prices less than the cost of production in order to spread overhead costs, were not made in "open and free competition" and were not properly to be considered in establishing a representative market price. (258 F.2d at 899) Again, here a Court recognized that not every sale is necessarily a "representative" sale.

The next decision by Judge Lynne was *Woodward Iron Co. v. Patterson,* 173 F.Supp. 251 (N.D. Ala. 1959). That case involved both coking coal and red iron ore. As to the red iron ore, it was found that there was no representative market or field price, so that the "proportionate profits" method of computation which the taxpayer desired to employ could be used. With respect to coking coal, Judge Lynne again found, consistent with his earlier decision, that a representative market existed in the Birmingham area and that a representative market or field price for coking coal could be determined. The Court then proceeded to de-

termine such price for the years in question without indicating in its opinion the precise manner in which such determination was made.

The final decision of Judge Lynne was *U.S. Pipe & Foundry Co. v. Patterson,* 203 F.Supp. 335 (N.D. Ala. 1962). That case involved coking coal and two different types or iron ore. As to the brown iron ore, it was held that there was a representative market or field price, so that the taxpayer could not use the proportionate profits method of computing depletion as it had sought to do. As to the red iron ore, it was found that there was no representative market or field price, and the taxpayer was permitted to avail itself of the proportionate profits method.

With respect to coking coal, Judge Lynne held to his previous view that there was a representative market or field price in the Birmingham region. He now said, however, he was convinced that he had been in error in *Woodward Iron* in that the prices arrived at were too high. 203 F.Supp. at 346, fn. 2. He then proceeded to determine new "representative market prices" for the years in question. In so doing it appears that the Court utilized sales of coking coal for purposes other than coking in determining the appropriate prices. It should be noted, however, that generally the sales for other than coking purposes were at prices higher than the prices commanded for coking purposes. 203 F.Supp. at 347. There is no indication whatsoever that in determining representative market prices the District Court utilized distress price sales "owing to peculiar economic conditions" of the type which had been condemned by the Court of Appeals in *Alabama By-Products,* supra. Further, the Court clearly distinguished between washed and unwashed coal prices and *utilized only the washed coal prices.*

In summary then the decisions have not held that a "representative" sale is any sale or that the statute commands

the courts to proceed in blind ignorance of the facts of particular transactions in seeking a representative market or field price. Rather the courts have held that selling "substantial quantities in the market affected by competitive bargaining and principles of supply and demand" will establish a representative market price (*U.S. Pipe & Foundry,* supra, p. 348). The courts have pointed out that a small number of sales is insufficient to furnish a market (*Cannelton,* supra, p. 78, footnote 2), that transactions will be excluded where "factors other than the market or field price [of the product involved] partly determined the market price" (*Shamrock Oil & Gas Corporation,* 35 T.C. 979, 1036 (1961)) that sales "owing to peculiar economic conditions" do not constitute a market (*Alabama By-Products,* supra, at p. 899) and that sales of a mineral product for a different use may not be "representative of the value of the product . . ." (*North Carolina Granite,* supra, at p. 161). The Commissioner himself in proposed regulations has taken the position that a representative market price is established by sales made by persons other than the taxpayer "only if such sales are the result of competitive transactions" and that "exceptional, nominal, unusual, tie-in or accommodation sales shall be disregarded." (31 F.R. 9508). With regard to comparisons of minerals, the Court in *United States v. Henderson Clay Products* (supra, 324 F.2d at 11-12) observed that the comparison should be on a basis "substantially equivalent by commercial standards" and that "physical, chemical and geological differences have importance only if they give rise to differences in commercial competition."

The sales relied upon by the District Court to establish a representative market price must be examined in the light of these principles.

The undisputed facts establish that, in the case of iron ore, the Utah Construction Company sales were in part for a different intended use, and all were made under "peculiar economic conditions" and not in a situation where principles of competitive bargaining determined the price.

In the case of coking coal, the facts establish that all the Kaiser sales were nominal, of a tie-in or accommodation nature and at less than cost and that all the Utah Fuel Company sales were for a different intended use, made under peculiar economic conditions at less than cost and were not the result of competitive transactions. The facts further establish that the "physical and chemical differences" in the Kaiser coking coal give rise to "differences in commercial completion" which must be recognized in the computation of any representative market price.

1. Iron Ore

a. Utah Construction Company

Central to the District Court's decision on the issue of iron ore is the finding that the transactions of Utah Construction Company established a representative market price for iron ore in the Western United States during the period in question. If this conclusion fails, the entire basis of the District Court's decision fails for there are no other iron ore transactions in the Western United States upon which reliance can be placed. There were only three consumers of blast furnace iron ore in the entire region and, except for the few Utah Construction Company transactions, each user produced its own requirements. (Admissions of Fact Nos. 2 and 7, R. 23-24).

During the two fiscal years in question Kaiser produced from its own mines between 75 and 80% of the iron ore required for its blast furnaces. The location of Kaiser's

plant at Fontana in San Bernardino County, California, was predicated upon the existence of the Eagle Mountain ore deposits. (Powell, Tr. 730, lines 11-13). The Utah source was not a permanent source, but only a supplemental ore source to be utilized until the Eagle Mountain mine went into full production. (Admissions of Fact No. 7, R. 24). The contract itself recited that Utah ore would only be purchased "until the railroad to the Eagle Mountain mine is completed." (Exhibit 2—June 1, 1946 amendment, p. 1)

The Utah ore deposits which served as an interim supply for Kaiser were first controlled by an individual named Senter Walker. During the 1940's Utah Construction Company had obtained a contract to do mining and stripping operations for Colorado Fuel and Iron Corporation. (Christensen, Tr. 489, line 7 to 490, line 8). Senter Walker arranged for Utah Construction Company to perform the same construction activities on this property. (Christensen, Tr. 490, lines 15-21).

In 1946, operating difficulties developed for Walker which threatended to close down his mine. Since Utah Construction had by this time built up an investment in its construction mining facilities, it was interested in continuing the operation, which had a satisfactory profit to it from a contractor's standpoint, at least until its investment in the loading equipment was recovered. (Christensen, Tr. 496, lines 9-14). Therefore, Utah Construction took over Walker's operation and entered into an agreement to complete the obligation which Walker had to furnish ore to Kaiser. At this time Utah Construction was concerned only with developing sufficient return to finance payoff of Walker's arrangement, to recover its investment in the equipment and to make the same construction company profit on the construction-type operation that it was performing in re-

moving iron ore from the property. (Christensen, Tr. 499, line 1 to 500, line 2). In arriving at the ore price under the contract, the previous price was simply continued and *no calculation was made as to the value of the ore.* (Christensen, Tr. 499, line 20).

Shipments for the years in question were made under a subsequent agreement arrived at by negotiation. When these prices were established, Kaiser was, for all practical purposes, Utah Construction's only customer and Utah was very much aware that other customers were necessary. (Christensen, Tr. 502, lines 13-17; 505, lines 8-20). Utah was also aware that while purchases of blast furnace grade ore by Kaiser would shortly cease, Kaiser would still have need for open-hearth grade ore and that it was desirable to continue this market if possible. The price reflected Utah Construction's cost of operation, payments under the Walker arrangement, and a profit "more from a contractor's standpoint . . . than as a commodity price". (Christensen, Tr. 507, lines 10-19). It was hoped in the long run to be able to utilize the Utah mine in shipments of blast furnace grade ore to other users and raise the price to "a fair commodity value". (Christensen, Tr. 508, lines 1-3). This uncontradicted testimony by Mr. Christensen, the former President of Utah Construction Company, clearly establishes that business considerations far different from the usual buyer-seller relationship were the reasons for the prices to Kaiser and that such prices were not the result of competitive considerations which gave rise to a representative market price. The situation closely parallels that considered in *Carey Salt,* supra, where special rock salt sales were excluded in determining representative market price.

The only other sales of blast furnace iron ore in any quantity during the years in question by Utah Construction

Company were sales to Kaiser-Frazer Parts Corporation, one sale to Geneva Steel Company, and a series of sales for export to Japan.[8] The Kaiser-Frazer Parts transaction was occasioned by the activity of that company in leasing a blast furnace at Ironton, Utah, in order to enable it to produce pig iron which it could exchange for steel needed in its automobile operations during a critical period. (Christensen, Tr. 504, lines 24 to 505, line 7). The sales to that company continued for only about a year until Kaiser-Frazer went out of business. Kaiser-Frazer Parts was a company affiliated with Kaiser Steel and the price to Kaiser-Frazer was tied to the price to Kaiser Steel. (Exhibit 2—Agreement April 2, 1948—attached Exhibit B). The transaction with Kaiser-Frazer Parts for the sale of ore and the price established therein was subject to all the same considerations which surrounded the transactions with Kaiser Steel and for the same reasons was in no way indicative of any normal buyer-seller relationship or of any representative market price.

The one sale to Geneva Steel Company in 1950 represented the clean-up by Utah Construction Company of stock piles of fine and soft ore which had accumulated as a residue from other sales. (Christensen, Tr. 531, line 12 to 532, line 5). The inordinately low price of $1.29 per ton (which was even lower and almost one-half of the price to Kaiser ($2.36 per ton)) was principally because of this fact. It was shipped to Geneva Steel at its blast furnaces in Provo, Utah. Under no circumstances is it proper to include this transaction in a determination of representative ore prices.

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8. The other transactions listed in Finding 22 (R. 36-7) consist of minimal sales to cement companies for use in making cement and sales of small quantities of open-hearth ore to foundries and to Carnegie-Illinois. These are all nominal sales either of a different commodity or for a special purpose (Christensen, Tr. 526-529).

It is clearly an unusual sale under distress circumstances of a mineral product of different grade.

The remaining transactions of any size were the export sales to Japan. Utah Construction Company was in fact the first and only shipper to the Japanese for some years. (Christensen, Tr. 513, line 24). The only shipments of iron ore to the Japanese from the United States during the period 1939 to 1950 were those made by Utah Construction Company. After World War II, when the Japanese steel industry was just beginning to get back on its feet, Utah Construction was approached by brokers and asked for an ore price. This had to be a price which would enable those brokers to make a sale to the Japanese steel industry (then controlled by the Supreme Command of the Allies in the Pacific) within the limits of bids which already had been made by them. (Christensen, Tr. 508-512). All sales were on the basis of spot shipments. The sales were made at a price which Mr. Christensen said was getting closer to a reasonable market price. (Christensen, Tr. 527, lines 16-20). The market for these sales was at Long Beach, California which was the point of shipment to Japan. It is much closer freightwise and geographically to Kaiser's Eagle Mountain mine than to the mines in Utah of Utah Construction Company. It is obvious that here again a temporary business opportunity was available to Utah Construction Company, in a market which had never existed theretofore and under circumstances, due to the military control of the market, which dictated that any price set had to fall within bids already made by brokers and without regard to the seller's evaluation of a proper price for its commodity. So far as Utah Construction Company was concerned, any price which it got for its commodity above that for which

it was selling to Kaiser was an improvement, but it still was not a representative market price for iron ore.[9]

The nominal amount of these sales affords another reason why they cannot be relied on. An expert economist so testified, (Carrier, Tr. 639, lines 20-25; 684, lines 11-14), and the uncontroverted facts in evidence support this conclusion. This witness, Mr. Carrier, stated that he had examined all the transactions which have been discussed. He further stated that market prices can only be set by market forces, which include the number and nature of buyers and sellers, the nature of the transactions involved, whether they are at arm's length, the bargaining power of the parties, the quantity of the commodity transferred, and the type of industry concerned. (Tr. 631, lines 6-19). Mr. Carrier pointed out that the total consumption of ore, as distinguished from transactions relied on, is significant in the determination of the existence of a market, and that the independent "sales" were such a small fraction of the total amount of iron ore consumed (Exhibit 3) that they cannot be relied on to establish a truly representative market price.

For all of the many and varied reasons just recited the Utah Construction sales did not establish a representative market price. In the language of the Commissioner's proposed 1966 regulation they were not the "result of competitive transactions", but were "exceptional, unusual and of a tie-in" nature and must be disregarded.

b. Lower Lake Port Prices

Since there were no actual transactions in the western United States which can be utilized to establish an appro-

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9. It is significant to note, with regard to the Utah sales, that the only market which Kaiser's Eagle Mountain mine could have participated in was the one at the Kaiser Fontana steel plant and the one at Long Beach, California, for export.

priate representative market price for Kaiser's ore, representative markets for the commodity involved in other parts of the United States must be referred to. The propriety of this approach was recognized in regulations proposed by the Commissioner himself in 1956. (21 Fed. Reg. 8439).[10] These proposed regulations provided (at p. 8450):

> ". . . the term 'market price' means the price . . . at which the gross income product is sold commercially in the vicinity of the taxpayer's mine. . . . If there are no such commercial sales in such area, then the market price of the gross income product . . . must be determined by the use of other appropriate methods with the objective of determining as accurately as practicable the price at which such gross income product would be sold if such commercial sales existed. Among such methods that may be appropriate, depending on the circumstances of each individual case, are the following:
>
> * * * * *
>
> (ii) Comparison of the prices at which crude mineral products or processed mineral products identical or similar to the taxpayer's gross income product are sold commercially *in other areas,* with proper adjustments being made for material differences, if any, between the taxpayer's gross income product and the product sold commercially (such as differences in kind or grade or mineral content or ordinary treatment processes involved or transportation costs between mine and market or relative volume of sales)" (Emphasis added).[11]

The only recognized United States iron ore market in which a substantial volume of transactions occurs at mar-

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10. Appendix D hereto. See Appendix, page 7.

11. It may be noted here that in 1966, while this case was still in the District Court, the foregoing proposed regulations were "withdrawn" and new regulations were proposed which omitted the foregoing language. 31 F.R. 9506.

ket prices fixed in arm's length dealings is at the Lower Lake Ports. This market has existed since the turn of the century. (Pardee, Tr. 584, lines 17-20). Reported prices for these transactions are available from standard reference sources. (Exhibit SS). It was undisputed that Kaiser's Eagle Mountain ore was of at least equal quality with Lower Lake Port ore of the "Mesabi non-Bessemer" classification. (Pardee, Tr. 583, lines 18-24). A representative market price for Kaiser's ore delivered to it at its Fontana plant should be the same as the price of Lower Lake Port ore on the docks at the Lower Lake Ports, taking into consideration the commercially applied and recognized adjustments for iron content, etc. These are the prices which Kaiser proposes to use.

The Lower Lake Port prices have frequently been used in connection with commercial transactions geographically distant from the Great Lakes. They have been used in leases for iron ore property as the basis for royalty to be paid, including leases on such properties in Utah (Christensen, Tr. 534). They have been used in valuing mining property—including property in California and Utah (Pardee, Tr. 590). They have been used in connection with setting of ore prices for foreign concessions (Christensen, Tr. 534). And most significantly they have been used by the Utah State Tax Commission as the base for valuing iron ores mined in Utah (Higgs, Tr. 623) rather than using sales prices, such as sales by Utah Construction Company (Christensen, Tr. 534).

In applying Lower Lake Port representative market prices the only adjustment under our facts is for Fe content of Kaiser ore (Exhibit SS, tables 14 and 15, pp. 234-5). It is a simple matter, therefore, to make this adjustment to Lower Lake Port prices for Mesabi non-Bessemer ore

as published for the years 1948, 1949 and 1950, to convert the prices thus arrived at from a calendar year to Kaiser's fiscal year basis and arrive at a representative market price for the Eagle Mountain and Vulcan ores. Since we are concerned with a mine price, it is also necessary to reduce this adjusted price by the freight from the Eagle Mountain and Vulcan mines to Fontana. These calculations are all reflected in the attached Appendix F and the resulting prices are as follows:

	Eagle Mountain Mine	Vulcan Mine
1949	$4.159	$4.472
1950	$5.132	(no shipments)

These are the representative market prices for Eagle Mountain and Vulcan ores.[12]

As further support for the use of these prices, Kaiser presented extensive economic evidence. This evidence, compiled over a period of thirteen years from 1948 to 1961, established that in the case of finished steel products of eastern producers, the relationship to the price of ore at Lower Lake Ports is such that about 93% of the variation in Lower Lake ore prices can be accounted for by the variation in the finished steel composite prices (Exhibit 7). For the same period, and with regard to pig iron prices of eastern producers, the relationship is such that over 97% of the variation in the Lower Lake ore prices can be accounted for by the variation in the composite pig iron prices (Exhibit 8). This direct relationship between ore price and pig iron and finished product price is striking. It shows that the ore price follows directly along with and is a function of the product price.

12. Appendix F hereto.

These product and pig iron prices of eastern producers have a very direct and immediate effect on pig iron and finished products produced in the western market. This is because there is substantial competition in the sale of steel products in the West between products produced by the purchasers and consumers of the Lower Lake Port ore from that ore and products produced by Kaiser from its ore. (Carrier, Tr. 650, lines 16-24). This competition included not only Kaiser but all the western producers and involved plate, shapes, sheets, strips, bars, pipe, tinplate, wire products and specialty items. It was a substantial competition. For example, in 1949 total consumption in the West of these competing items was 4.3 million tons, of which western production capacity accounted for 2.2 million tons and eastern production the balance (Howard, Tr. 823-829). Even though no Lower Lake Port ore is sold or consumed as ore in the western United States, such ore does find its way into these finished products. Neither ore, therefore, exists in a vacuum independent from the other. These price relationships between pig iron and finished products are such that during the period 1949 through 1961, more than 99% of the variations in pig iron and finished steel product prices at Kaiser's Fontana mill can be accounted for by the competition from eastern producers (Exhibits 5 and 6).

Where such competition between end products exists, the evidence also established that comparable cost-price relationships can be expected to occur between raw materials and the finished product in the different geographical areas (Carrier, Tr. 645-650) and that competition in final products develops uniformity in price for raw materials (Carrier, Tr. 660, lines 12-23). These relationships between ore and pig iron, or finished product, are such that in a free market it is possible to predict from the pig iron prices

an ore price within an accuracy of 3% (Carrier, Tr. 667) and if a similar free ore market had existed in the West, the same accuracy was to be expected (Carrier, Tr. 666). Applying these principles, a computation was made by Mr. Carrier from which he concluded that he would have anticipated in a free western market that Kaiser would have had an ore price at Eagle Mountain of $5.17 for the fiscal year 1949 and $5.92 for the fiscal year 1950 (Exhibits 11 and 12), making allowance for the fact that in the years 1948, 1949 and 1950 the relationship between ore and pig was slightly below the average for the entire eleven years which he considered in his study. This testimony fully supports use of the representative market prices computed in accordance with the method reflected in the attached Appendix F.

The District Court rejected the use of the Lower Lake prices upon the basis that ". . . the Great Lakes area was an independent market insofar as the plaintiff is concerned and sales within that independent market area had no economic effect upon the plaintiff's market area . . ." (Finding 33, R. 40). This finding lacks any support in the evidence and is completely contrary to all of the undisputed evidence in the record. The economic effect upon Kaiser's market area of the Lower Lake Port prices was conclusively demonstrated by Mr. Carrier's testimony to which we have referred above. It was conclusively shown that price of finished products produced from the Lower Lake Port ore has a direct and provable relationship to the price of that ore. It was further conclusively shown that those finished products are in direct competition with finished products produced from western ore and that they were in competition with each other in plaintiff's market area. Exactly similar economic relationships were shown between finished

product prices in the East and the West and pig iron. The conclusion is inescapable that western ore prices are affected by eastern ore prices and that these afford a representative market price.

c. Application of Representative Market Price

Even if we are to assume that the action of the District Court in rejecting Lower Lake Port prices as establishing a representative market price is to be upheld, the decision of the District Court in establishing a representative market price derived from Utah Construction Company sales constitutes clear reversible error. The District Court concluded that a weighted average of the mine prices realized by Utah Construction Company from *all* of its sales constituted the representative market price to be applied at Kaiser Eagle Mountain and Vulcan mines in California. This mine price was a mine price realized by Utah Construction Company in the State of Utah. It was a mine price derived from sales made to users of ore in many different and diverse geographical locations, (remote from Kaiser's mines in California), from sales made of open-hearth ore as well as blast furnace grade ore (even though Kaiser's mines in California produced no open-hearth ore) and from sales made of essentially waste products entirely dissimilar to the high-grade iron ore produced at Kaiser's California mines (such as the sale to Geneva Steel Company).

It is apparent that the District Court absolutely misconceived the meaning of "representative market price." It concluded that any mine price realized at the mine in Utah was a "representative market price" and was the mine price which would have been realized at Kaiser's mines in California. The Court's error lies in its assumption that the realized mine price in Utah would be the same in California, and it arises primarily from the fact that the mar-

ket in which the representative market price would be created was not given any consideration. The Court was not confused as to the proper rule since in Conclusion of Law No. 7, it stated, "The representative market price of a mineral is the price that is actually paid by buyers for a mineral product of like kind and grade in the same market." (R. 52) The Court, however, misapplied the rule.

The "price actually paid by buyers" in any market consists of the gross amount which that buyer must spend to obtain the product he desires either at a well-established market where the product is traded and sold, such as the Lower Lake Ports, or, in the absence of such a well-established market and in the case of isolated transactions such as exist here, at the place where the buyer takes the product for use.

The only justification for using market prices received by others in order to arrive at a representative market price for a taxpayer who has made no sales, is upon the premise that such a taxpayer would or could have competed in and sold his product in the same market. Thus it presupposes that the Kaiser Fontana mill or the Long Beach, California, export shipper would have been willing to pay the same amount of money to obtain Kaiser's Eagle Mountain ore as in fact was paid to obtain Utah Construction Company's ore. The market is the place where that buyer takes the ore and not at the mine of Utah Construction Company or the Eagle Mountain mine. The representative market price obviously consists of the gross amount which that buyer pays. The "mine" price which is to be used for the purpose of depletion can only be arrived at by deducting from the representative market price paid by the buyer the segment of that price which consists of the cost of delivering that ore from the mine to the buyer.

This principle is well illustrated by the situation which, in fact, exists at the Lower Lake Ports. The "representa-

tive market price" is established at the Lake Erie Ports. For Mesabi non-Bessemer ore, for example, it was $7.70 in 1950 (Exhibit SS, Table 17, p. 240). This price included the price at the mine, the rail and freight rates, dock and loading charge, transportation tax, interest, insurance and incidentals. In the case of a mine owner in Minnesota, the cost of moving this ore from the mine to the Lower Lake Ports market was $2.30 and he realized a mine price of $5.075 (Exhibit SS, Table 17). However, in the case of a mine in Wisconsin or upper Michigan which shipped from the Eastern Marquette Range, the cost of transporting that same ore to the same market was $1.905 (Exhibit SS, Table 16). He thus realized a mine price of $5.46. It is difficult to believe that any court would conclude that the Michigan producer would be required to use a mine price of $5.075 for depletion purposes simply because this was the price that was realized by the Minnesota producer.

The concept of adjusting the representative market price by transportation costs between the mine and the market in order to arrive at a mine price has been recognized by the Commissioner. The regulations proposed by him in 1956 listed among the pricing factors to be considered "transportation costs between mine and market." (21 F.R. 8450)[13]

The concept was also recognized, approved and accepted by the Government in connection with Kaiser's original tax returns (Exhibits Q and R).

The concept was expressly recognized by the Government itself in connection with the trial of this very matter. It is visually and clearly demonstrated by Exhibit JJ, which the Government itself prepared and introduced into evidence. The Government's own witness, Dr. Jones, testified in support of the procedure, stating (Tr. 859, lines 9-13):

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13. Appendix D hereto, Appendix, page 7.

> "I wouldn't want to compare the price at Eagle Mountain with the value of the ore at Utah. I don't think it can be done that way. You have to consider how far away they are from Fontana, and that is the adjustment I made."

So clear, indeed, is the propriety of this method of determining a representative "mine" price that Kaiser had no reason to suppose it was at issue in the proceeding until the District Court's Findings were received. So startling was the position adopted that Kaiser urged it as a ground of surprise sufficient to require a new trial so that the evidence of the Government's acceptance of the well-established principle could be introduced (R. 67-69).

The basic question is which representative market prices are to be used so that a mine price can be derived from them to be applied at Kaiser's mines in California. Here, again, the decision of the District Court is based upon substantial reversible error. As pointed out above, the Court did not use representative market prices but instead used Utah mine prices. However, even in selecting the mine prices to be used, the Court misconstrued the applicable rule. In its Findings, the Court said that the prices to be used were those paid by buyer "in the same market" (Conclusion of Law No. 7, R. 52-53). This same language recognizing that it must be in the "same market" appears in Finding No. 8 (R. 53). The Court applied this rule to exclude the Lower Lake Port prices "because of the remoteness of the sites of such sales from the area of plaintiff's operations and the absence of any sales or shipments of such ore to the area of plaintiff's operations." (Finding 33, R. 40). However, when it came to considering the Utah Construction Company sales, the decision throws a blanket over each and every one of those sales, irrespective of whether they were made in the same market as Kaiser's

operations or in the area of Kaiser's operations. Looking at the Utah Construction Company ore sales (Finding 22, R. 36-37), it is readily evident that the only sales in the same market as or in the area of Kaiser's operations were the sales to Kaiser at Fontana, California, and the sales for export to Japan at Long Beach, California. We have already shown that all other sales must be disregarded, irrespective of their not being in the area of Kaiser's operations, for the separate reasons that they represented sales of a different commodity or sales under peculiar and unusual circumstances of a distress nature. We repeat that, in addition to these reasons for disregarding them, there is the equally compelling reason that they were made in unrelated geographical markets. As Conclusion of Law No. 7 states, "prices paid by buyers in unrelated geographical markets . . . have no bearing on the representative market price of the mineral." (R. 53)

With regard to the sale to Kaiser at its Fontana mill, we have clearly demonstrated that this must be disregarded because of the exceptional and unusual circumstances surrounding it, with the consequence that it did not establish any representative market price. If we are to use any of the Utah sales for the purpose of a representative market price, the only ones which come close to establishing such a price are the export sales made at Long Beach. These were sales of blast furnace grade iron ore made at Long Beach which is in the market area Kaiser could have served from its California mines. These were sales at prices which were getting closer to a representative market price (Christensen, Tr. 527, lines 16-20).[14]

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14. The Utah *mine* prices at which these export sales were made (1948—$3.18, 1949—$3.78 and $2.36) are proof in themselves that the prices at which Utah sold to Kaiser Steel (1948—$1.88, 1949—$2.18) are not a representative market price for Kaiser's Ore.

The representative market price of these export sales at Long Beach, California, (consisting of the mine price and the average freight) was $7.65 in 1948 and $8.30 and $7.06 in 1949 (Exhibit 1). In order to arrive at a mine price to be used for depletion purposes at Kaiser's mines in California, it is necessary to deduct from this representative market price the transportation cost from Kaiser's mines to Long Beach. These freight costs were, on the average, $2.40 (Ferrum, California, to Long Beach, Exhibit 27, and Eagle Mountain to Ferrum, Exhibit 10). The result is a mine price at Kaiser's Eagle Mountain mine of $5.25 for the 1948-49 sales and $5.90 and $4.66 for the 1949-50 sales. These are the mine prices Kaiser would have realized based upon the representative market price for the export sales. This compares with the $2.29 for 1948-49 and the $2.03 for 1949-50 set forth in Finding 35 (R. 41).

2. Coking Coal

The representative market price for coking coal was based solely upon the prices received by Kaiser for a small volume of transfers to third parties from its production at Sunnyside Mine No. 2 and prices received by Utah Fuel Company from its production at Sunnyside Mine No. 1 (Findings 51 and 52, R. 45). The Court's conclusion that these transactions are to be used at all is completely contrary to the principles of the regulations (present and proposed) and the decided cases (Supra, pp. 18 to 27). Such transactions should be disregarded because all of them were of either a tie-in or accommodation nature, or in a nominal amount, or were made for an entirely different use under peculiar economic conditions which resulted in their being made at less than cost and not as the result of competitive transactions.

A representative market price was established by the sales of coking coal made in the open market by Raton Coal Company to Colorado Fuel and Iron Corporation. The Court found that these coals "competed directly in the market place" with Kaiser's Sunnyside coal (Finding 70, R. 50). The Court nevertheless failed to use any of the prices for such coal in arriving at a representative market price.

In arriving at a "representative market price", the Court disregarded the uncontradicted evidence that regular commercial and market practices (1) require upward adjustments in determining the price for Kaiser's coking coal because of (a) it being a washed coal instead of an unwashed coal, and (b) its low ash content, and (2) do not recognize any penalty for the sulphur content or lower plasticity of the Sunnyside coal. Instead, the Court found, contrary to all the evidence, that somehow these recognized advantages of the Kaiser coal had been minimized. (Finding 69, R. 50) and failed to make any such adjustments.

a. Sunnyside Mines

Kaiser obtained its high volatile coking coal requirements from Sunnyside Mine No. 2 in Utah. This coal was mined by Kaiser. In addition, Kaiser purchased lesser amounts of Oklahoma-Arkansas low volatile coking coal for blending purposes.

The Sunnyside coal field is located in Carbon and Emery Counties in Utah. It is one of the two significant fields of high volatile coking coal in the Western United States. Columbia-Geneva Steel owned and operated its coking coal properties in the Sunnyside field (Heiner, Tr. 309-311) adjacent to the Sunnyside mines.

The Sunnyside mines (known as Nos. 1 and 2) were owned for many years by Utah Fuel Company. Although

Utah Fuel Company owned a number of other mines from which coal for domestic and general business purposes was produced and sold, the Sunnyside mines were the only ones which produced coal with coking properties. The Sunnyside No. 2 mine was closed down by Utah Fuel Company in 1924 and remained closed until 1942 when a ten-year lease was entered into with Kaiser for this property. (Heiner, Tr. 325-327). Utah Fuel Company, however, had kept the Sunnyside No. 1 Mine open and made certain sales of coal from that mine.

The testimony of Mr. Heiner, the former President of Utah Fuel Company, was that the company had not been able to operate the Sunnyside No. 1 Mine at a profit since 1929. (Tr. 331, lines 8-11). This resulted from the fact that although the coal produced was a coking coal and valuable for coking purposes, the same coking characteristics made it unsuitable and not salable for commercial or domestic use. (Heiner, Tr. 414, lines 10-15). The coal made coke trees and plugged up stokers. (Heers, Tr. 66, lines 23-25). It was too smoky, dirty and tough to handle. (Heiner, Tr. 330). However, the No. 1 Mine was kept open and sales at less than cost for commercial and domestic purposes were made from it (Heiner, Tr. 416) because, as the President of Utah Fuel Company testified, it was recognized that limited reserves of coking coal were available in the West and when the steel industry expanded in the West, the property and its coking coal could become much more valuable when used for the making of coke in the production of steel. (Tr. 331; 373, lines 19-22). Except for this expectation, Utah Fuel would have closed the mine down because its coking coal could not compete in the commercial and domestic market due to its unsuitability for that use (Heiner, Tr. 328-330; 347-349; 417).

The hoped for expansion of the steel industry in the West began to emerge when Kaiser commenced production of steel in the western United States during World War II. Utah Fuel Company was able to reopen its No. 2 Mine by leasing it to Kaiser in 1942. Kaiser operated the mine under lease during the tax years in question, and utilized virtually all the production in Kaiser's own steel making operations. However, the expansion at that time was not sufficient to include Utah Fuel's No. 1 Mine and, in order to keep it open, that company was forced to continue its practice of making commercial and domestic sales at less than cost. Ultimately, the expansion did include Utah's No. 1 Mine in 1950 when Kaiser purchased it to add to its coking coal reserves. (Finding 48, R. 44).

During the tax years in question, Kaiser made sales from its own production in amounts as indicated in Finding No. 41 (R. 42-43). These transactions all were in extremely small amounts, were of an accommodation nature and were made at cost.

The representative market price established by Finding 52 (R. 45) is based entirely upon the sales made by Utah Fuel Company in the tax years in question out of its Sunnyside No. 1 Mine and upon the small volume of sales made by Kaiser out of its Sunnyside No. 2 Mine. Let us turn first to the sales made by Utah Fuel Company. Finding 46 (R. 44) is in accordance with the evidence and establishes that "all or nearly all of the Sunnyside coal that it (Utah Fuel Company) sold was used by the purchasers for heating purposes or for making steam rather than for making coke." Other than this brief statement the Findings do not reflect in any respect the circumstances surrounding these sales by Utah Fuel Company. Here again we find the Court falling into the error of assuming that simply because there was a

sale, the price realized from that sale automatically becomes a "representative" market price irrespective of the circumstances. This, however, is not the law. In the words of the Commissioner's proposed 1966 regulations, such prices are to be taken into consideration "only if such sales are the result of competitive transactions" and "exceptional, nominal, unusual, tie-in or accommodation sales shall be disregarded." (Appendix E, Appendix, pages 16-28).

The actual circumstances, as disclosed by the evidence, show that these sales by Utah Fuel Company cannot establish a representative market price. These facts and circumstances are that the coal produced by Utah Fuel from its Sunnyside No. 1 Mine was not "salable for commercial or domestic use" (Tr. 414, lines 10-12), that Utah Fuel had to hunt for places to sell this coal (Tr. 328, line 17), that the coking characteristics of this very coal made it unsuitable for commercial or domestic sale, and that the only reason the company kept the mine open and attempted to make any sales from it was for the significantly different business purpose of ultimately disposing of the property in the coking coal market (Tr. 373, lines 19-22). Prices established by such sales, irrespective of the profit they might produce, are clearly not made under any competitive conditions which could give rise to a representative market price. They can only be classified as sales made under peculiar economic conditions and, in effect, distress sales. We are not aware of any court decision which has included this type of sale in establishing a representative market price. On the contrary, the *Carey Salt Company* case, supra, the *North Carolina Granite Corporation* case, supra, and the Fifth Circuit Court of Appeals in the *Alabama By-Products Corporation* case, supra, have held that this type of sale was not properly to be considered in establishing a representative market price.

One of the most significant pieces of evidence which the Court overlooked is that from 1929 on, the Utah Fuel Company was unable to operate the Sunnyside No. 1 Mine at a profit and that the sales made from that mine were, during this entire period (except for the last year of 1949), made at less than cost. It is difficult to conceive how any transaction which occurs at cost or less than cost can be regarded as being in any sense a representative transaction, particularly where the sales made are occasioned by a desire to accomplish an ulterior business purpose and without regard to any normal considerations of competitive market or supply and demand. It is more difficult to understand how these sales at less than cost can be considered when in Finding 41 (R. 42) the Court excluded from its computations of representative market price a transfer made by Kaiser from its Sunnyside No. 2 Mine with the following language—"but this was made at cost and is not treated here as a sale." Perhaps we can best summarize the circumstances surrounding these transactions in the words of Mr. Heiner, the President of Utah Fuel Company, when he testified as follows:

> "We had tried every means we could to introduce the Sunnyside coal to our regular commercial dealer trade, but the Sunnyside coal was not wanted; they wouldn't have Sunnyside coal as such because it was too smoky and too dirty a coal to burn in the ordinary stoker or even in the grates or fireplaces—we couldn't sell it to dealers—we hadn't operated No. 1 Mine at a profit in all my knowledge and from company records it had been a losing proposition beginning in 1929 until at least 1949—our one hope was to keep that Sunnyside mine open to fit into the coking coal picture somehow." (Tr. 330-331).

The inclusion, as a part of a weighted average for determining representative market price, of the sales made by Kaiser Steel Company from its Sunnyside No. 2 Mine is even more mystifying. Here, again, the surrounding facts are not considered or weighed by the Court except in a very strange way. In Finding 41 (R. 42) it is stated that the coking coal from Sunnyside No. 2 Mine was "suitable" for non-coking uses. There is no evidence in the record to support this statement. All of the evidence is to the contrary, as pointed out above in connection with the Utah Fuel Company sales. The Court then finds that "such sales were made in competition with sales of coal *not* suitable for coking." When we examine these sales, we find that they consist of the following: *First,* the largest of them is a transfer at cost to Columbia Geneva Steel Company which operated an adjacent coking coal property for the purpose of accommodating and helping out in case of strike, exchange of coal for testing, or exchange of coal by reason of encroachment on the property of the other (Admissions of Fact, paragraphs 23, 24 and 25, R. 25-26; Heers, Tr. 94-95). *Second,* there were accommodation transfers made to Utah Fuel Company, the landlord, in the taxable year 1950 to help it out with one of its customers (Heers, Tr. 96) and other accommodation transfers made in the taxable year 1949, partly occasioned by the necessity of equalizing washer tonnage due to the fact that both Sunnyside Mines No. 1 and No. 2 utilized the same washing facilities (Heiner, Tr. 335-336). *Third,* the other sales "made in competition" consist of a 54-ton transaction with Permanente Metals, an affiliated company to whom coal was sold at cost for testing (Heers, Tr. 95, 116), and two transactions with the Denver & Rio Grande Western Railway, resulting out of bad order cars(Heers, Tr. 97, 107, 117). The complete misconseption

of the nature of these sales is again most strikingly illustrated by the fact that these transactions were made at cost according to the undisputed evidence (Heers, Tr. 95, 97, 107, 116, 123). The Court in Finding 41 (R. 42) recognized that transfers at cost are *not* to be treated as sales when it so stated with regard to the transfer made by Kaiser Steel to Kaiser-Frazer Parts. Although we are admittedly prejudiced in this matter, it seems most clear that none of the transactions involving Utah Fuel Company or Kaiser Steel Corporation can, under any reasonable view of the evidence or the law, be regarded as having established any representative market price.

b. Raton Coal Company (Koehler) Mines

The testimony is uncontroverted that available sources and reserves of coking coal are extremely scarce in the West (Heers, Tr. 80, 81). The only fields in the years in question from which high volatile coal could be secured for coking purposes by the western steel industry were (1) the Sunnyside area in Utah, which contained the mines from which Kaiser Steel obtained its coking coal and the mines from which Columbia Geneva obtained its coking coal, and (2) the Raton Mesa area in southern Colorado and northern New Mexico which contained the mines from which Colorado Fuel and Iron Corporation obtained its coking coal (Kastler, Tr. 190; Keenan, Tr. 245-249, 251-253; Heiner, Tr. 311). The mines in the Raton Mesa area were for that reason of considerable interest to Kaiser Steel as being the only other proven source of coking coal in the West and the next best source to Sunnyside (Heers, Tr. 109).

The St. Louis, Rocky Mountain & Pacific Company (referred to as the Raton Coal Company) owned and operated the Koehler, Brilliant and Van Houten mines in this Raton

Mesa field which produced coking coal (Exhibit 34, Dunn Deposition, Exhibit C, pages 3, 4, 5, 6; Findings 65, R. 48). Colorado Fuel and Iron Corporation produced coking coal from its own mines in the Raton Mesa area. Colorado Fuel and Iron Corporation also purchased high volatile coking coal for use in its steel making processes. Nearly all of the purchases of high volatile coking coal by Colorado Fuel and Iron Corporation were from Raton Coal Company in the taxable years in question (Finding 65, R. 48). These purchases were in very substantial amounts, consisting of 491,980 tons in the calendar year 1948, 336,619 tons in the calendar year 1949, and 345,897 tons in the calendar year 1950 (Exhibit H). These very substantial sales of high volatile coking coal clearly represent an established market, and it is equally obvious that a representative market price resulted. These were the only sales of high volatile coking coal in the West for coking purposes (other than incidental purchases in relatively small tonnages made by Colorado Fuel and Iron Corporation from other producers in the Raton Mesa area) and the only sales of coking coal for any purpose which were made in the course of competitive transactions.

It is clear that these actual sales transactions competed in the same market as Sunnyside (i.e.—the market at the Fontana, California steel plant). This results from the fact that the freight rate from the Raton Coal Company mines to the Kaiser Steel plant at Fontana was the same as the freight rate from the Sunnyside mines to Fontana. In 1946, a specific request was made for the establishment of such an equal freight rate, and this rate was actually established in 1949 (A. Heiner, Tr. 786-787; Exhibit 30). If Kaiser Steel had desired to make any shipments of coal from Raton at an earlier date, such as 1948, the railroad would have equalized the freight rates at such time (A. Heiner, Tr. 787).

In view of these facts the Court very properly concluded that "the Raton Mesa coal and the Sunnyside coal of the plaintiff competed directly in the market place, were both suitable for production of coke when blended with low volatile coal and were similarly utilized. . . ." (Finding 70, R. 50).

It would seem to follow naturally from this finding that in arriving at a representative market price for the Sunnyside coal, the Court would have included the quantities and prices of the coking coal sales from Raton to Colorado Fuel and Iron. *This was not done.* These sales are brushed off by a vague finding to the effect that they "confirm the fact that the sales price obtained by Utah Fuel Company for its Sunnyside coal was representative of the market price. . . ." (Finding 71, R. 50). On the contrary, these prices even without making the necessary adjustments for difference in ash content and washing loss, confirm the fact that the prices obtained by Utah Fuel Company were *not* representative. The sales prices from Raton Coal Company to Colorado Fuel and Iron average $5.08 in 1948, $5.24 in 1949 and $5.44 in 1950 (Exhibit H). This compares with the average price received by Utah Fuel Company for substantially smaller tonnages of $4.80 in 1948, $4.79 in 1949 (Finding 47, R. 44) and approximately $4.50 for the first two months of 1950 (Finding 49, R. 44).

It is clearly reversible error for the District Court not to have also used the sales by Raton Coal Company to Colorado Fuel and Iron Corporation for the establishment of a representative market price.

Finding No. 65 (R. 48) lists other tonnages sold by Raton Coal Company in addition to the sales made to Colorado Fuel and Iron Corporation. All of these sales, with very few exceptions, were for commercial or domestic purposes

and did not take into account the ash adjustments and the adjustments for washing costs which are recognized commercial practices in the West in the pricing of coal to be used for coking purposes. These adjustments will be discussed in the next section of this brief. If any use were to be made of these sales, these adjustments would have to be computed and the record does not contain evidence which would enable this computation to be made. Practically all of the tonnage sold by Raton was to Colorado Fuel and Iron and the Santa Fe Railway and all of this coal was sold in an unwashed condition (Kastler, Tr. 195, 221). It is interesting to note that in any event the price of the unwashed coal sold to Santa Fe Railway was approximately the same as the price of the unwashed coal sold to Colorado Fuel and Iron. Other than these, the sales were in small amounts and were entirely for steam or domestic purposes (Kastler Tr. 184, 189). The prices indicated for the sales to retail dealers, which are extremely low, reflect the same deficiencies in coking coal for domestic uses as was found to be the case by Utah Fuel Company when it engaged in its distress sales of coking coal for domestic use.

The significant sales made by Raton Coal Company, so far as the present case is concerned, are those made to Colorado Fuel and Iron Corporation. These are the sales which establish a representative market price. This was the principal market which Raton Coal Company had. These were the only sales made for coking use (Kastler, Tr. 191-195). The Court has found that these sales competed directly in the market place with the plaintiff's Sunnyside coal. These are the sales which must be used in order to determine a representative market price for Kaiser's Sunnyside coal.

c. Recognized Commercial Price Adjustments

As mentioned earlier, the most important factors in coking coal and the thing which steel manufacturers are buying when they purchase coking coal is the fixed carbon in this coal. This is the element in coking coal which provides the fuel in the blast furnace. Thus, it is desirable to obtain as much fixed carbon as possible when purchasing coal (Finding 54, R. 45).

The most undesirable element in coking coal and the thing which steel manufacturers desire not to purchase is ash. Ash is the term used in the coking coal industry to describe the impurities in coal other than volatile matter, sulphur and phosphorus. (Finding 58, R. 46). Per unit of weight, the fixed carbon increases as the ash decreases.

Coal as mined contains ash in the form of "free impurity," sometimes called rock or shale (Exhibit 36, Bertholf Deposition, page 10), which can be removed from the coal by washing. Coal as mined also contains ash in the form of "inherent ash" which cannot be eliminated from the coal by any commercially feasible washing or cleaning process. (Exhibit 36, Bertholf Deposition, page 11). In order to remove the ash existing as a "free impurity" from the coal, washing of coal is practiced as a normal operation throughout the West and is an ordinary treatment process. (Heers, Tr. 89; Keenan, Tr. 267-268). All of the decided cases to date involving representative market prices for coking coal, including *Alabama By-Products, Woodward Iron* and *United States Pipe,* have distinguished between washed and unwashed coal in determining prices. It is quite obvious that each ton of coal which has been purchased and is then washed will after washing weigh less than a ton because of the elimination of the "free impurity." This loss suffered in the course of washing is referred to in the trade as the "washing yield." For example, the coal purchased

by Colorado Fuel and Iron from Raton's Koehler mine in 1949 had an 83.07% yield after washing—in other words, of each ton of coal as purchased, only 83.07% of that ton remained for use in the coke oven after the washing process was completed (Exhibit 36, Bertholf Deposition, page 24).

The coal produced from the Raton mines and purchased by Colorado Fuel and Iron was in an unwashed condition. The coal produced from the Sunnyside mines by Kaiser for which it is necessary to construct a price was in a washed condition. In arriving at a representative market price for *washed* Sunnyside coal, based upon prices for *unwashed* Raton coal, an adjustment must be made. The Government's own witness, Mr. Johnson, agreed that adjustments would have to be made as between washed and unwashed coal in order to get comparable prices, that these adjustments would make a substantial difference, that they would consist in the washing costs and a percentage for the washing loss, and that all in all this might make around a dollar's difference (Tr. 1017-1020) in favor of the Sunnyside Coal.

The testimony is uncontradicted that it is a recognized commercial practice to pay more for coal with a lower ash content and that differences in ash content are definitely recognized in pricing coal. (Heers, Tr. 87; Keenan, Tr. 268, 271, 291; Heiner, Tr. 351-352). The testimony is that the price adjustment ranges from 10¢ per unit of ash up to 30¢ to 40¢ per unit of ash. The ash content of the Sunnyside coal in a washed condition was 7.1% in 1949 and 6.8% in 1950. (Finding No. 59, R. 46). The ash content of the Raton coal was 11.8% in 1949 and 12.3% in 1950. (Finding No. 66, R. 49). In order to arrive at a representative market price for the Sunnyside coal based upon the sales prices of

the Raton coal, an adjustment in accordance with the recognized commercial practice is required. This is the same type of adjustment made in all of the iron ore markets of the world in adjusting price as the iron (Fe) content increases or decreases.

The principle of using regularly established commercial price adjustments is enunciated in the *Henderson Clay Products* case, supra. In that case, the Court observed (at p. 11-12) that any comparison of minerals should be on such a basis that "they are substantially equivalent by commercial standards," and that "physical, chemical and geological differences have importance only if they give rise to differences in commercial competition." (324 F.2d at 11). The District Court affirmed this rule in Conclusion of Law No. 6 (R. 52). It is undisputed in this record that differences in ash content do give rise to price differences in commercial competition and that washing costs and losses likewise give rise to price differences.

The attached Appendix G reflects the computation which has been made in order to give effect to these recognized commercial price adjustments. The starting point is the price paid by Colorado Fuel and Iron for the *unwashed* Raton coal. We are, of course, seeking to arrive at a representative market price to be used for washed Sunnyside coal. The first adjustment therefore gives effect to the loss of tonnage which is suffered in the course of washing process in order to make the comparison one which is "substantially equivalent by commercial standards." To this we then add washing costs since this is clearly an ordinary treatment process which can be taken into account in connection with a depletion price. Finally, the price is adjusted to reflect the regularly established commercial price adjust-

ment because of the lower "inherent ash" of the Sunnyside coal. The result is a representative market price of $6.585 in 1949 and $6.933 in 1950.[15]

These are the prices which should be used as the representative market price for the Sunnyside coal. By way of comparison, the representative market price adopted in this case by the District Court was $4.75 for 1949 and $4.87 for 1950. (Finding No. 52, R. 45).

Finding No. 69 (R. 50) suggests there are commercially accepted adjustments which are made for sulphur and plasticity. This, however, is not supported by the record. As to plasticity, the testimony is that differences in plasticity do not result in any penalty and that the benefits or detriments are not recognized in price (Heers, Tr. 158-159; Keenan, Tr. 290; Johnson, Tr. 997; Tr. 1012, lines 21-25). While sulphur is, of course, a detriment in coal, this is only the case if it exists in sufficient quantities in the resultant coke so that it becomes troublesome in the blast furnace process. At least in western practice, sulphur content under 1% is of no concern. (Keenan, Tr. 273).

d. Oklahoma-Arkansas Coking Coal

In making coke for use in the steel-making processes in the West, the uniform practice of all steel producers, including Kaiser, Columbia-Geneva and Colorado Fuel and Iron, is to blend together a large portion of high volatile coal with a small portion of low volatile coal to arrive at

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15. Insofar as ash adjustment is concerned, the computation could be made by using an average of the dollar and cents per point of difference of ash, to which the witnesses testified. This average would be 35¢. It is quite obvious that this would substantially increase the representative market price. For example, in 1949, there was a 4.7% ash difference. We have, therefore, adopted the more conservative method of adjusting for the difference in ash on a simple ratio basis.

a coke of optimum strength at the most economic cost. The reason for this is that neither high volatile coal nor low volatile coal can be used alone in making a satisfactory coke. (Findings 60 and 61, R. 46-47). The low volatile coals purchased by each of the three steel producers come from mines in the Oklahoma-Arkansas region of the United States. (Finding No. 62, R. 47).

The volumes of low volatile coal purchased by all of these consumers were considerable. For the tax year July 1, 1948-June 30, 1949, they were 372,425 net tons, and in the tax year July 1, 1949-June 30, 1950, they were 482,252 net tons. (Exhibit 19, page 2).

The existence of a completely representative market with regard to this coking coal is clearly evidenced by the fact that purchases and sales at arm's length took place between a number of producers and a number of consumers, as reflected in Exhibits 19 and 28. The market consisted of independent buyers and independent sellers. There also can be no question but that these transactions took place in the same market area as that served by Raton Coal Company and the Sunnyside mines since the same consumers were buying this coal as were using the high volatile coal produced from the Sunnyside and Raton mines.

While it is true, as the Court has found, that the Oklahoma-Arkansas coals could not be used as a complete substitute for the Sunnyside coal in the coke-making process, it is equally true, as the District Court has found, that both of these coals were required in order to make a satisfactory coke, with the good points of one supplementing the good points of the other. Both of them are used for the same identical purpose. If these factors are to be recognized, it seems completely logical to compute an alternative representative market price based upon a weighted average of

the adjusted Raton prices as reflected in Appendix G for the Sunnyside coal produced by Kaiser and the Oklahoma-Arkansas prices for the Oklahoma-Arkansas coal purchased by Kaiser. Such a computation is attached as Appendix H and indicates a price of $6.63 for the tax year ended 1949 and $6.86 for the tax year ended 1950. This constitutes an alternative representative market price to be used for the Sunnyside coal.

E. CONCLUSION

We have tried to review fairly the largely uncontroverted facts in this case. We are intensely aware that the key issue in this case is the determination of a "representative market or field price", which is a factual question. We submit that in determining this question all of the facts surrounding each of the transactions must be considered and that this lack of consideration is the basic error in the decision of the District Court and in the proposed Findings and Conclusions of Law submitted by the Government in this case to the District Court (R. 119-144), which the District Court used in substantially verbatim form as its own Findings and Conclusions.

To us it is clear that these sales transactions relied upon by the District Court for the purpose of establishing a representative market price, when viewed in light of all of the circumstances surrounding those transactions, are not the result of competitive transactions and therefore must be disregarded. Each of them were sales of an exceptional, nominal, unusual, tie-in or accommodation nature. The extraordinary economic conditions surrounding the ore sales by Utah Construction Company and the coal sales by Utah Fuel Company are readily apparent. The nominal tie-in and accommodation nature of the coal transactions

by Kaiser Steel Corporation are equally apparent. The principles enunciated in the decided cases and in the Commissioner's regulations require that these sales be disregarded.

No one can dispute that the Lower Lake Port ore market establishes a truly representative market price. The evidence clearly supports the use of the prices establishd at this market in fixing a representative market price for Kaiser's iron ore. The interconnection and interdependence between the eastern and western markets has been clearly established and is not disputed. The representative market price for Kaiser's iron ore should be computed in the manner set forth in the attached Appendix F.

As a separate point, and regardless of what opinion anyone may have as to which transactions are to be used for the establishment of a "representative market or field price," the failure to recognize the freight differentials in the case of Kaiser's iron ore as a function of representative market price is obvious error. Likewise, any use of transactions other than those bearing some indicia of competitive transactions, such as the Long Beach, California export sales, cannot be justified.

The validity of the coal transactions between Raton Coal Company and Colorado Fuel and Iron Corporation as establishing a representative market price is made clear by the District Court's own Findings. These sales competed in the same market as served by Kaiser's Sunnyside mine. The price adjustments for washing cost and loss and for ash content are recognized adjustments made in the commercial market. There is no dispute in the record on this score. Accordingly, the representative market price for Kaiser's Sunnyside coal should be established in the manner set forth in the attached Appendix G. In the alternative,

these representative market prices should be established on the basis of a weighted average including transactions in the recognized Oklahoma-Arkansas market as set forth in the attached Appendix H.

It is respectfully submittted that this case should be reversed and remanded to the trial court with instructions that plaintiff's depletion allowance shall be computed on the basis of representative market prices established in accordance with these principles and that judgment should be entered in favor of plaintiff for the amount so computed.

Dated: February 9, 1968

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By Edward J. Ruff
Attorneys for Appellant

F. CERTIFICATE OF ATTORNEY

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Edward J. Ruff
Attorney

(Appendices follow)

G. APPENDICES

Appendix A

Table of Exhibits

EXHIBITS:

Appendix B

Section 114(b)(4), 1939 Internal Revenue Code

(A) In General.—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, ball, sagger, and china clay, phosphate rock, rock asphalt, mines, trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine), and potash mines or deposits, 15 per centum, and in the case of sulfur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(B) Definition of Gross Income From Property.—As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining", as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulfur—pumping to vats, cooling, breaking, and loading

for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; and (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 731 and 735.

Appendix C

Regulations 111, Section 29.23(m)-1

In the case of a crude mineral product other than oil and gas, "gross income from the property", as used in section 114(b)(4)(A) means the gross income from mining. The term "mining" as used herein includes not only the extraction of ores or minerals from the ground but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products.

If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product. If there is no such representative market or field price (as of the date of sale) then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

Appendix D

Regulations Proposed on November 3, 1956, 21 Federal Register 8439, 8450

Regs. Section 1.613-3(b) and (c)

(b) *Gross income from mining.* (1) The term "gross income from the property", as used in section 613(c)(1), means, in the case of a property (other than an oil or gas property), gross income from mining. For the purposes of this paragraph, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "non-mining transportation". (See § 1.613-3(c) (7) for definition of the term "mining".)

(2) "Gross income from mining" is the portion of the taxpayer's gross income which is attributable to the extraction of the minerals from the mine, the application to the crude mineral product (see § 1.613-3(c)(1)) of ordinary treatment processes (see § 1.613-3(d)) and mining transportation.

(3) Examples of the application of the rule described in subparagraph (2) follow:

(i) If a taxpayer sells

(*a*) The crude mineral product without any transportation costs having been incurred, or

(*b*) The processed mineral product (see § 1.613-3(c)(2)) without any transportation costs having been incurred, or

(*c*) The processed mineral product as to which only mining transportation costs have been incurred,

"gross income from mining" means the amount for which such mineral product was sold.

(ii) If a taxpayer sells

(*a*) The crude mineral product as to which transportation costs have been incurred, or

(*b*) The manufactured product (see § 1.613-3(c)(3)) as to which no ordinary treatment processes were applied and no transportation costs were incurred, or

(*c*) The manufactured product as to which no ordinary treatment processes were applied and transportation costs were incurred,

"gross income from mining" means the market price (as of the date of the sale of the mineral product referred to in (*a*) and the manufactured products in (*b*) and (*c*) of this subdivision) of the untransported crude mineral product referred to in (*a*) of this subdivision, or the untransported crude mineral product used to produce the manufactured products referred in (*b*) and (*c*) of this subdivision.

(iii) If a taxpayer sells

(*a*) The processed mineral product as to which only non-mining transportation costs have been incurred, or

(*b*) The processed mineral product as to which both mining and non-mining transportation costs have been incurred, or

(*c*) The manufactured product as to which ordinary treatment processes have been applied and no transportation costs have been incurred, or

(*d*) The manufactured product as to which ordinary treatment processes have been applied and only mining transportation costs have been incurred, or

(*e*) The manufactured product as to which ordinary treatment processes have been applied and only non-mining transportation costs have been incurred, or

(*f*) The manufactured product as to which ordinary treatment processes have been applied and both mining and non-mining transportation costs have been incurred,

"gross income from mining" means the market price (as of the date of sale of the products referred to in (*a*) through

(*f*), of this subdivision) of a processed mineral product obtained by applying to the crude mineral product the ordinary treatment processes actually applied and mining transportation costs actually incurred by the taxpayer to produce the particular mineral product described in (*a*), (*b*), (*c*), (*d*), (*e*) and (*f*) of this subdivision.

(4) The mineral product to which the market price (referred to in subdivision (ii) and (iii) of subparagraph (3)) is applied is designated, herein, as the "gross income product". For the purpose of this paragraph the term "market price" means the price (as of the date the taxpayer actually sells his crude mineral product or processed mineral product or manufactured product, as the case may be) at which the gross income product is sold commercially in the vicinity of the taxpayer's mine. However, in no case shall the market price of the gross income product exceed the amount actually realized from the gross income product. If there are no such commercial sales in such area, then the market price of the gross income product (as of the date the taxpayer sells his crude mineral product or processed mineral product or manufactured product as the case may be) must be determined by the use of other appropriate methods with the objective of determining as accurately as practicable the price at which such gross income product would be sold if such commercial sales existed. Among such methods that may be appropriate, depending on the circumstances of each individual case, are the following:

(i) Comparison with the prices at which crude mineral products or processed mineral products similar to the taxpayer's gross income product are sold commercially in the vicinity of the taxpayer's mine with proper adjustment being made for material differences, if any, between the taxpayer's gross income product and the products sold com-

mercially (such as differences in kind or grade or mineral content or ordinary treatment processes involved or transportation costs between mine and market or relative volume of sales).

(ii) Comparison with the prices at which crude mineral products or processed mineral products identical or similar to the taxpayer's gross income product are sold commercially in other areas, with proper adjustments being made for material differences, if any, between the taxpayer's gross income product and the products sold commercially (such as differences in kind or grade or mineral content or ordinary treatment processes involved or transportation costs between mine and market or relative volume of sales).

(iii) Computation based on the taxpayer's cost of producing the gross income product plus a rate of profit (determined to be appropriate) per unit of product, per dollar of cost, or per dollar of investment in mining. Such rate of profit may be ascertained:

(*a*) By comparison with the rate of profit currently realized on commercial sales of identical or similar crude mineral products or processed mineral product, or

(*b*) By comparison with the rate of profit currently realized by the taxpayer on sales of his products, or

(*c*) By comparison with a rate of profit ascertained by any other appropriate method.

In utilizing comparative prices for the determination of market prices, greater weight should be given to prices (1) of commercial sales made closest in time to the sale of the mineral product by the taxpayer, (2) of mineral products most nearly similar to the gross income product of the taxpayer, and (3) of mineral products sold commercially in areas closest to the mines of the taxpayer. In utilizing the

taxpayer's costs of producing the gross income product in determining its market price, only costs actually incurred shall be taken into consideration. Such costs will usually be reflected on the books and records the taxpayer maintains for cost control and other ordinary business purposes. Certain deductions allowed for tax purposes in the nature of special incentives, such as that of accelerated amortization of emergency facilities under section 168, for exploration and development expenditures under sections 615(a), and 616(a), respectively, and similar deductions, would not ordinarily be taken into consideration in determining market prices as set out above.

(5) The rule with respect to manufactured products described in subparagraph (3) (ii)(*b*), and (*c*) and (iii) (*c*), (*d*), (*e*) and (*f*) and subparagraph (4) that the market price of the gross income product must be computed as of the date that such manufactured product is sold by the taxpayer shall not apply in cases where the taxpayer shows to the satisfaction of the Commissioner that it is impractical and unrealistic to require him to compute the market price of the gross income product as of the date he sells the end product. In such exceptional cases, the taxpayer may compute the market price as of the date he transports the gross income product from the premises of the mine to the manufacturing facilities. A taxpayer shall employ this method only so long as he can demonstrate his inability reasonably to compute the market price of his gross income product as of the date he sells the manufactured product and only to the extent that there results no distortion of the allowance for depletion. Any taxpayer employing this method must consistently compute cost depletion by using as the number of units of mineral sold, the same number of units used in the determination of the gross income product transported from the premises of the mine.

(6) To the return of a taxpayer computing gross income from mining under subparagraph (4) above, there shall be attached a statement describing the gross income product involved and the method or methods employed by the taxpayer in determining the market price of the gross income product. Such statement shall include:

(i) If comparative prices were used—

(*a*) The prices so used, and

(*b*) Any adjustments that were made because of differences between taxpayer's gross income product and the mineral product used for comparison.

(ii) If costs were used—

(*a*) The costs so used,

(*b*) The rate of profit applied,

(*c*) The method used in determining the rate of profit, and

(*d*) Any comparative rates of profits used and the reasons for their use.

(iii) If any other method or combination of methods were employed, complete details and computations involved in using these methods, and

(iv) Any additional data necessary for a complete understanding of the method or methods employed and the computations involved in determining the market price.

(c) *Definitions of terms applicable to gross income from mining.* Where used in section 613(c) and paragraphs (b) and (c) of this section, the term—

(1) "Crude mineral product" means the mineral in the form in which it emerges from the mine.

(2) "Processed mineral product" means the mineral product which is obtained by application to the crude mineral product of one or more of the ordinary treatment processes.

(3) "Manufactured product" means the product which is obtained by the application to the crude mineral product or processed mineral product of processes which are not ordinary treatment processes.

(4) "Mineral product" means the crude mineral product or processed mineral product.

(5) "Commercially marketable mineral product or products" means the mineral product or products sold by the taxpayer or used by him in his trade or business whether in the form of crude, or processed mineral product.

(6) "Mine owners or operators" refers to taxpayers who are engaged in mining as defined in subparagraph (7) below. Where a taxpayer both engages in mining and applies to the crude mineral product or processed mineral product processes other than ordinary treatment processes, he is a "mine owner or operator" with respect to the extraction of minerals from the mine and the application to such minerals of ordinary treatment processes, but with respect to the application of other than ordinary treatment processes he is a manufacturer. Thus, the term "mine owners or operators" in the term "ordinary treatment processes normally applied by mine owners or operators" refers to the taxpayer in his capacity as an operator of a mine and not in his capacity as a manufacturer.

(7) "Mining" includes not only the extraction of ores or minerals (other than oil and gas) from the ground but also the ordinary treatment processes which are normally applied by mine owners or operators to the crude mineral product after extraction to obtain the commercially marketable mineral product or products. The term "mining" also includes so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which

ordinary treatment processes are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills, the transportation over such greater distance. (See paragraph (e) of this section for filing of application to treat transportation in excess of 50 miles as mining.)

(8) "Extraction of ores or minerals from the ground" means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of prior mining. The preceding sentence does not apply to any such extraction of ores or minerals by the purchaser of such waste or residue or the purchaser of the rights to extract ores or minerals from such waste or residue. The term "purchaser" does not apply to any person who acquires mineral property, including such waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue. The term "purchaser" also does not apply to a lessee, upon the renewal of a mineral lease without an intervening lapse, if the lessee was entitled to a depletion allowance upon ores or minerals produced from such waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term "purchaser" does include a person who acquires such waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. It is immaterial whether the waste or residue result from the process of extraction from the ground or from application of the

ordinary treatment processes provided for in § 1.613-3(d). However, extraction of ores or minerals from waste or residue which results from processes which are not allowable as ordinary treatment processes is not treated as mining. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

Appendix E

Regulations Proposed on July 13, 1966, 31 Federal Register 9506

Regs. Section 1.613-3(b)-(d)

(b) *Minerals other than oil and gas*—(1) *In general.* The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the processes of extraction of the ores or minerals from the ground, the application of mining treatment processes, and transportation which qualifies as "mining." For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before January 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after December 31, 1960) will be referred to as "mining treatment processes." Processes and transportation which do not qualify as mining will be sometimes referred to as nonmining processes. Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation." See paragraph (f)(1) of this section for the definition of the term "mining."

(2) *Sales prior to the application of nonmining processes and nonmining transportation*—(i) Subject to the provisions of subdivision (ii) of this subparagraph and the adjustments required by paragraph (e) of this section, "gross income from mining" means the amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral—

(*a*) As it emerges from the mine, prior to the application of any process other than a mining treatment process or any transportation,

(*b*) After the application of only mining treatment processes, and prior to any transportation, or

(*c*) After application of only mining treatment processes, and after only mining transportation.

(ii) Subdivision (i) of this subparagraph shall not apply in any case where the price for which the ore or mineral is sold is established by means of a violation of the Sherman Anti-Trust Act of July 2, 1890, 26 Stat. 209, 15 U. S. C. 1-7, as amended, or by means of a violation of a similar State or Federal law. In case the price is so established, "gross income from mining" shall be determined in accordance with paragraph (c) of this section, if it is possible to ascertain a representative market or field price for the taxpayer's ore or mineral; if it is impossible to ascertain a representative market or field price, there shall be used such evidence of a fair market price for the taxpayer's ore or mineral as may be available. Unless it has been determined by the final judgment of a court of competent jurisdiction or it is alleged in a criminal or civil proceeding instituted by a Federal, State, or local government, or an agency thereof, that the price for which the ore or mineral is sold was established by such a violation, for purposes of this subparagraph it shall be deemed that the price is not so established.

(c) *Sales after the application of nonmining processes or nonmining transportation where a representative market or field price for the taxpayer's ore or mineral can be ascertained*—(1) *General rule.* If the taxpayer processes or transports the ore or mineral before sale (other than by mining treatment processes or mining transportation), "gross income from mining" means the representative market or field price of an ore or mineral of like kind and grade

as the taxpayer's ore or mineral after the application of only the mining treatment processes actually applied and before any nonmining transportation, subject to any adjustments required by paragraph (e) of this section. If it is possible to determine a representative market or field price under the provisions of this paragraph, the taxpayer's "gross income from mining" shall be determined on the basis of such price rather than under the provisions of paragraph (d) of this section.

(2) *Criteria for determining whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral.* An ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral if, in common commercial practice, it is regarded as sufficiently similar in chemical or physical characteristics to the taxpayer's ore or mineral that it is used or is economically suitable for use for essentially the same purpose as the use to which the taxpayer's ore or mineral is put. In determining whether an ore or mineral is of like kind and grade as the taxpayer's, an ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral even though the chemical or physical characteristics (including size) of such ore or mineral are not precisely identical to those of the taxpayer's ore or mineral. For example, in the case of a taxpayer who mines and uses his bituminous coal in the production of coke, all bituminous coals having coking quality suitable for commercial use by coke producers are considered to be of like kind and grade as the coal mined and used by the taxpayer. Similarly, the fact that the taxpayer applies slightly different size reduction processes or applies slightly different beneficiation processes than are applied to an ore or mineral which meets the standard of the first sentence of this subparagraph will not, in itself, prevent such ore or mineral from being considered to be of

like kind and grade as the taxpayer's ore or mineral. On the other hand, the fact that two ores or minerals are suitable for the same general commercial use will not cause the two ores or minerals to be considered to be of like kind and grade if the desirable constituents of the two ores or minerals are markedly different substances. For example bauxite will not be considered to be of like kind and grade as iron ore merely because the final products manufactured from these ores are used for a common purpose, *i.e.*, structural uses. Similarly, coal will not be considered to be of like kind and grade as natural gas merely because both coal and natural gas may be used as fuel.

(3) *Factors to be considered in determining the representative market or field price for the taxpayer's ore or mineral.* In determining the representative market or field price for the taxpayer's ore or mineral, consideration shall be given only to prices of ores or minerals of like kind and grade as the taxpayer's ore or mineral and with which, under commercially accepted standards, the taxpayer's ore or mineral would be considered to be in competition if it were sold under the conditions described in paragraph (b)(2)(i) of this section. As among such prices primary consideration shall be given to prices for sales during the taxable year (with appropriate adjustment in the event of price changes within such taxable year) of ores or minerals:

(i) Most similar, after the application of mining treatment processes, to the taxpayer's ore or mineral, and

(ii) Produced from mines closest to the mine of the taxpayer. In the event that the individual criteria listed above each tend to support different prices, the determination of which of the two criteria should be accorded the greater importance will depend on the facts and circumstances of the individual case. A weighted average of the selling price of ores or minerals of like kind and grade as the taxpayer's,

beneficiated only by mining treatment processes, in the marketing area of the taxpayer's mine, although not a prerequisite to the determination of the representative market or field price, may assist in the determination of such price. The identity of the relevant market, and the price within such market which is the representative market or field price, are necessarily factual determinations to be made on the basis of the facts and circumstances of each individual case.

(4) *Type of sales which may be considered in determining the representative market or field price for the taxpayer's ore or mineral.* Sales of ores or minerals of like kind and grade as the taxpayer's will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral only if such sales are the result of competitive transactions. For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, exceptional, nominal, unusual, tie-in, or accommodation sales shall be disregarded.

(5) *Information to be furnished by a taxpayer computing gross income from mining by use of a representative market or field price.* A taxpayer who computes his gross income from mining pursuant to the provisions of this paragraph shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for his ore or mineral and the source of his information as to such price or prices.

(6) *Limitation on gross income from mining computed under the provisions of this paragraph.* No price shall be considered a representative market or field price for the taxpayer's ore or mineral if the sum of such price plus the costs of the nonmining processes which the taxpayer applies to his ore or mineral exceed the taxpayer's actual sales price of the product sold. For example, if the costs of non-

mining processes applied by the taxpayer to coal for the purpose of making coke are \$12 per ton, and the taxpayer's actual sale price for such coke is \$18 per ton, a price of \$7 per ton would not be a representative market or field price for the taxpayer's coal.

(d) *Sales after the application of nonmining processes where a representative market or field price for the taxpayer's ore or mineral cannot be ascertained*—(1) *General rule.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c)(1) of this section, then, except as provided in subparagraph (2) of this paragraph, there shall be used the representative market or field price of the first marketable product, minus the sum of—

(*a*) The direct and indirect costs allocable to nonmining processes and

(*b*) The proportionate profits attributable to such processes, and subject to any adjustments required by paragraph (e) of this section. See § 1.611-0.

(ii) The proportionate profits attributable to nonmining processes are determined by multiplying the profit described in subdivision (iii) of this subparagraph by a fraction whose numerator is the sum of the direct and indirect costs paid or incurred by the taxpayer and allocable to nonmining processes and whose denominator is the sum of all costs, direct and indirect, paid or incurred by the taxpayer to produce, sell, and transport such first marketable product.

(iii) The profit referred to in subdivision (ii) of this subparagraph is the difference between the representative market or field price of the first marketable product and the taxpayer's total costs (direct and indirect) paid or incurred to produce, sell, and transport such product.

(iv) In determining the amount of the indirect costs allocable to nonmining processes, all of the indirect costs which

are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product shall be fairly apportioned between mining and nonmining.

(2) *Computation of gross income from mining by use of a method other than the proportionate profits method*—(i) If, for taxable years beginning more than 90 days after the publication of this paragraph of § 1.613-3 of the Income Tax Regulations in the Federal Register as a Treasury decision, circumstances exist which, in the taxpayer's opinion, make the use of the proportionate profits method inappropriate in his case, the provisions of subdivision (ii) or (iii) of this subparagraph are applicable in computing gross income from mining by use of another method. Such alternative method shall be acceptable only if the taxpayer establishes to the satisfaction of the district director (in the case of a method used pursuant to subdivision (ii) of this subparagraph) or of the Commissioner (in the case of a request made pursuant to subdivision (iii) of this subparagraph) that the proportionate profits method does not clearly reflect gross income from the property, and the proposed alternative method clearly reflects gross income from the property.

(ii) Except as provided in subdivision (iii) of this subparagraph, if a taxpayer uses a method other than the proportionate profits method the taxpayer shall file, with his income tax return for the first taxable year beginning more than 90 days after the publication of this paragraph of § 1.613-3 of the Income Tax Regulations in the Federal Register as a Treasury decision for which use of such other method is desired, a statement containing the following information:

(*a*) An explanation of the circumstances which make it impossible to ascertain a representative market or field price for the taxpayer's ore or mineral;

(*b*) A concise statement of the reasons why the computation of gross income from mining is not clearly reflected by the use of the proportionate profits method;

(*c*) A description of the method or methods used by the taxpayer to compute his gross income from mining during the previous taxable years to which the Internal Revenue Code of 1954 is applicable;

(*d*) A concise description of the method the taxpayer proposes to use in lieu of the proportionate profits method; and

(*e*) Computations of the taxpayer's gross income from mining for the taxable year for which such alternative method is used, and for either of the two taxable years immediately preceding such taxable year, by use of—

(*1*) The proportionate profits method, and

(*2*) Such alternative method, had it been used for such years.

The district director may require such other information as may be necessary in order to determine whether adoption or continued use of the alternative method will be permitted. Whether or not the taxpayer's use of such method should be permitted and whether or not the use of such method may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the district director in connection with the examination of the taxpayer's income tax returns. Such method, once adopted, shall continue to be used in all subsequent taxable years for which it is necessary to compute gross income from mining in accordance with the provisions of this paragraph, unless the use of a different method is (*a*) required by the district director, or (*b*) authorized by the Commissioner upon written request filed in the manner prescribed by subdivision (iii) of this subparagraph.

(iii) In lieu of following the procedure set forth in subdivision (ii) of this subparagraph, the taxpayer may submit a request to the Commissioner of Internal Revenue, Washington, D. C. 20224, within 90 days after the beginning of the first taxable year beginning more than 90 days after the publication of this paragraph of § 1.613-3 of the Income Tax Regulations in the Federal Register as a Treasury decision for which the taxpayer desires to use such other method. Such request must contain the same information required by subdivision (ii) of this subparagraph, except that the computations required by subdivision (ii) (*e*) shall be made for any two of the three taxable years immediately preceding the year for which application is made. The Commissioner may require such other information as may be necessary in order to determine whether adoption of the proposed method will be permitted. Once approved, such method shall continue to be used in lieu of the proportionate profits method in the absence of (*a*) the approval of the Commissioner for the adoption of another method upon written request therefor, or (*b*) a material change in the taxpayer's operations or other material facts that requires, in the opinion of the Commissioner, that a different method be utilized in order clearly to reflect the taxpayer's gross income from the property.

(iv) For taxable years subsequent to the first taxable year to which the provisions of subdivision (ii) or (iii) of this subparagraph apply the taxpayer shall attach to his income tax returns for such subsequent taxable years a statement indicating whether gross income from mining has been computed by a method other than the proportionate profits method and, (*a*) whether, if a method was used to which subdivision (ii) applies, such method was permitted in the examination of the taxpayer's return for prior taxable years, or (*b*) if a request submitted pursuant to the

provisions of subdivision (iii) of this subparagraph has been approved by the Commissioner, the date such approval was granted.

(v) Subdivisions (i) through (iv) of this subparagraph shall not apply with respect to taxable years beginning before the 91st day following the publication of this paragraph of § 1.613-3 of the Income Tax Regulations in the Federal Register as a Treasury decision. In the case of taxable years beginning before such date, if the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects gross income from the property, then such gross income shall be computed by the use of such other method.

(3) *Costs to be used in computing gross income from mining by use of the proportionate profits method or another method based on the taxpayer's costs.* The objective of the proportionate profits method is to determine what portion of the sale price of the taxpayer's product is attributable to mining, and what portion to nonmining operations, through application of the assumption that each dollar of cost (both direct and indirect) paid or incurred to produce, sell, and transport the mineral earns the same percentage of profit. In determining the taxpayer's gross income from mining by use of the proportionate profits method or another method based on the taxpayer's costs, only costs actually incurred shall be taken into consideration. Such costs will usually be reflected on the books and records which the taxpayer maintains for cost control and other ordinary business purposes, including such internal records as may be maintained for management purposes. In general, if the taxpayer has employed in a consistent manner a method of determining the direct costs of the various individual phases of his activities (such as loading for ship-

ment, calcining, extraction, etc.) which is reasonable, does not result in the allocation of nonmining costs to mining treatment processes, or vice versa, and is in keeping with sound accounting practice, such method shall not be disturbed. In cases where the taxpayer maintains different cost records for tax purposes and for non-tax purposes, the cost or other accounting records maintained for non-tax purposes, if reasonable and maintained in keeping with sound accounting practice, shall be used in determining mining and nonmining costs provided that their use does not result in the allocation of nonmining costs to mining treatment processes, or vice versa. For example, even though a taxpayer elects to take a deduction for amortization of emergency facilities for the taxable year under section 168, he shall, in computing his "gross income from mining" under a method which utilizes the taxpayer's costs, substitute for the amount deducted for amortization of emergency facilities a figure which represents a reasonable deduction for depreciation based on the useful life of the assets. If only a portion of the property is subject to amortization under section 168, then the deduction shall be determined without regard to section 168. Similarly, if exploration or development costs are deducted in the year paid or incurred under section 615(a) or section 616(a), the taxpayer shall, nevertheless, in computing his "gross income from mining" for the taxable year under a method which utilizes his costs in determining such constructive income, take into account as costs the amount which would have been deductible for such taxable year if they had been deferred in accordance with section 615(b) or section 616(b). Furthermore, the charges for depreciation which the taxpayer maintains for ordinary business purposes, where reasonable and in keeping with sound accounting practice,

shall be used in lieu of depreciation allowances under accelerated methods permitted as tax deductions.

(4) *Treatment of particular items in computing gross income from mining by use of the proportionate profits method or another method based on the taxpayer's costs*—(i) In determining gross income from mining by use of the proportionate profits method or any other method which is based on the taxpayer's costs, the costs and profits attributable to "mining transportation" shall be included, that is, so much of the transportation of ores and minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the mining treatment processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Where such plants or mills are in excess of 50 miles (or of such greater distance approved by the Commissioner) from the point of extraction from the ground, then costs incurred for transportation in excess of 50 miles (or of such greater distance) to the treatment plant shall be treated as "nonmining" costs in determining "gross income from mining." Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. See also paragraph (g)(3) of this section, relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the costs attributable to such excess transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation to the treatment plant as the distance of the excess

transportation is to the distance of the total transportation.

(ii) In determining "gross income from mining" by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, a process shall not be considered as a mining treatment process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, drying, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nonmining costs in determining "gross income from mining." If a mining treatment process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining "gross income from mining." Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of methods which will more clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, the cost attributable thereto shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining "gross income from mining" by use of the proportionate profits method (or an alternative method which the district director approves and which is based on the taxpayer's costs), the costs attributable to containers, bags, packages, and similar items as well as the costs of materials and labor attributable to bagging, packaging, or similar operations shall be considered as nonmining costs. Accordingly, all profits attributable thereto are treated as nonmining profits.

Appendix F

Page 1

KAISER STEEL CORPORATION

Computation of Weighted Average Representative Market Price for Eagle Mountain Iron Ore and Vulcan Iron Ore Years Ended June 30, 1949 and 1950

Year Ended	Net Tons Shipped (Finding No. 15, R. 34)	Price per N.T. f.o.b. Mine*	Product (1) × (2)	Weighted Average Price f.o.b. Mine (3) ÷ (1)
6/30/49:				
Eagle Mountain ore mine				
7/1/48 - 12/31/48	74,611 N.T.	$3.584	$ 267,406	
1/1/49 - 6/30/49	202,044	4.371	883,134	
	276,655 N.T.		$1,150,540	$4.159
Vulcan ore mine				
7/1/48 - 12/31/48	113,914 N.T.	4.263	$ 485,615	
1/1/49 - 6/30/49	54,056	4.912	265,523	
	167,970 N.T.		$ 751,138	$4.472
6/30/50:				
Eagle Mountain ore mine				
7/1/49 - 12/31/49	388,016 N.T.	4.903	$1,902,442	
1/1/50 - 6/30/50	447,199	5.331	2,384,018	
	835,215 N.T.		$4,286,460	$5.132
Vulcan ore mine				
No shipments				

*See page 2 of this appendix F

Appendix F—Page 2

KAISER STEEL CORPORATION

Computation of Representative Market Price for Eagle Mountain Iron Ore and Vulcan Iron Ore Years Ended June 30, 1949 and 1950

	Price per Gross Ton at Lower Lake Ports				Price per Net Ton at Mine		
	Lake Superior Ore (1)		KSC Ore				
	Published Price	For Fe Content of	Fe Content (2)	Adjusted Price	KSC Ore Adjusted Price/NT	Less Frt. KSC Mine to Fontana	Price f.o.b. Mine
6/30/49:							
Eagle Mountain ore mine							
7/1/48 - 12/31/48	$6.20	51.5%	54.02%	$6.503	$5.806	$2.222(3)	$3,584
1/1/49 - 6/30/49	7.20	51.5	52.82	7.384	6.593	2.222(3)	4.371
Vulcan ore mine							
7/1/48 - 12/31/48	6.20	51.5	53.23	6.408	5.721	1.458(4)	4.263
1/1/49 - 6/30/49	7.20	51.5	51.03	7.134	6.370	1.458(4)	4.912
6/30/50:							
Eagle Mountain ore mine							
7/1/49 - 12/31/49	7.20	51.5	53.20	7.438	6.641	1.738(3)	4.903
1/1/50 - 6/30/50	7.70	51.5	52.95	7.917	7.069	1.738(3)	5.331
Vulcan ore mine							
No shipments							

Notes: (1) Exhibit SS, 1950 edition, tables 14 and 15, pages 234-5, Mesabi Non-Bessemer ore.
(2) Exhibit AAA.
(3) Exhibit V.
Exhibit S, attached sheet 3 of 4.

Appendix G

KAISER STEEL CORPORATION

Computation of Representative Market Price for Sunnyside Coal by Reference to Sales Price of Koehler Coal from Raton Coal Company to CF & I

	Year Ended 6/30/49	Year Ended 6/30/50
Sales price from Raton Coal Company to CF & I—unwashed/NT (Exhibit H)*	$5.240	$5.333
Divided by yield per CF & I of 87.39% and 84.81% after washing to arrive at mine price of coal in one ton of washed coal (Exhibit 36, Bertholf deposition, pages 24-5)	5.996	6.288
Add: Sunnyside washing costs per ton of washed coal (Frantz, Tr. 837)	.216	.196
Profit on washery operation—estimated (Frantz, Tr. 837)	.040	.040
Cost per net ton of washed coal at mine (the Sunnyside situation) with Raton ash	$6.252	$6.524
To adjust for differences in ash content as between Sunnyside coal and Raton Coal:		
Above prices divided by the ratio developed between the Raton average ash content of 11.8% and 12.3% (or 88.2% and 87.7% yield of pure coal) and Sunnyside average ash content of 7.1% and 6.8% (or 92.9% and 93.2% yield of pure coal) (Exhibit 16)		
Representative market price of Sunnyside coal	$6.585	$6.933

*Government Exhibit H shows that purchases of coking coal from Raton by CF & I during the calendar year 1949 amounted to 336,619 tons. The correct figure is 345,888 tons. See plaintiff's exhibit 28; Exhibit 34 (Dunn deposition) Ex. C, page 3; and Exhibit 36 (Bertholf deposition) page 26. The incorrect figure affects District Court Finding No. 64.

Appendix H

Weighted Composite Average of Sunnyside and Oklahoma-Arkansas Prices

Sunnyside: Price (Appendix G)	Sunnyside: Net Tons (Finding No. 36, R. 41)	Oklahoma-Arkansas (Ex. 29): Weighted Avg. Price	Oklahoma-Arkansas (Ex. 29): Net Tons
	1949		
$6.585	416,615	$6.99	56,473(1)
	Weighted Average Price—6.63		
	1950		
$6.933	591,568	$6.26	65,845
	Weighted Average Price—$6.86		

(1) Excluding inter-company transfer from Kaiser-Frazer Parts Corp. of 3,360 tons at $10.00 per net ton.

No. 22,272

In the United States Court of Appeals for the Ninth Circuit

KAISER STEEL CORPORATION, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

On Appeal from the Judgment and Order of the United States District Court for the Northern District of California

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BRIEF FOR THE APPELLEE

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No. 22,272

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v.

UNITED STATES OF AMERICA, APPELLEE

On Appeal from the Judgment and Order of the United States District Court for the Northern District of California

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BRIEF FOR THE APPELLEE

OPINION BELOW

The findings of fact and conclusions of law of the United States District Court for the Northern District of California (I-R. 31-55)[1] are not officially reported.

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[1] "I-R." references are to Vol. 1 of the reproduced record and "II-R." references are to the transcript of the proceedings below.

JURISDICTION

This appeal involves federal income taxes. The taxes in dispute are for the fiscal years ending on June 30, 1949 and June 30, 1950. Taxes in the total amount of $7,170,062.27 for the taxable year 1949 were paid on November 3, 1949; December 6, 1949, March 2, 1950 and June 14, 1950. (I-R. 2, 15.) Taxes in the total amount of $7,971,088.80 for the taxable year 1950 were paid on September 15, 1950; December 11, 1950; March 6, 1951 and June 15, 1951. (I-R. 4, 16.) Claims for refund for each of the above-stated fiscal taxable years were filed by taxpayer on October 14, 1953. (I-R. 6-14, 32-33.) In its claim for refund for the taxable year 1949, taxpayer claimed an additional depletion deduction in the amount of $207,168 (I-R. 7, 32) and on the basis thereof claimed a refund to be owing it in the amount of $78,723.84 (I-R. 2, 6). In its claim for refund for the taxable year 1950, taxpayer claimed an additional depletion deduction in the amount of $333,275 (I-R. 12, 33) and on the basis thereof claimed a refund to be owing it in the amount of $126,644.50. (I-R. 4, 11). The claims for refund were denied by letter dated March 21, 1956. (I-R. 2-3, 4.) Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on March 21, 1957, taxpayer brought an action in the District Court for the recovery of taxes paid for the years 1949 and 1950. (I-R. 1-14.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The judgment of the District Court was entered on November 18,

1966. (I-R. 56.) A motion to amend findings of fact and conclusions of law, to make additional findings of fact and conclusions of law, to alter or amend judgment, and for a new trial was filed by taxpayer on November 21, 1966. (I-R. 57-81.) An order denying the motion was entered on May 26, 1967. (I-R. 82-83.) Within sixty days thereafter, on July 20, 1967, taxpayer filed a notice of appeal. (I-R. 84.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

It is undisputed that taxpayer's depletable "gross income from mining" coal and iron ore, during the taxable years, was the "representative market or field price * * * of a mineral product of like kind and grade," under applicable Treasury Regulations. The question is whether the District Court correctly determined the "representative market or field price" for each mineral.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutory and regulatory provisions are set forth in the Appendix, *infra.*

STATEMENT

The material facts, as found by the District Court (I-R. 33-50), may be summarized as follows:

Taxpayer is an integrated miner-manufacturer which mines coal and iron ore and uses these minerals (together with purchased coal and iron ore) in the

manufacture of iron and steel products. As an intermediate manufacturing operation, it produces coke by processing coal it mines and purchases through its by-product coking ovens. The coke, together with a given quantity of iron ore and other materials, is charged into a blast furnace from which iron is obtained. During the taxable years taxpayer mined coal from leased properties at Sunnyside, Utah, and iron ore from its Vulcan Mine in San Bernardino County, California, and its Eagle Mountain Mine in Riverside County, California. (I-R. 33-34.)

During the taxable years taxpayer mined at Sunnyside and shipped to its production facilities the following net tonnages of coal (I-R. 41):

Fiscal year ended June 30, 1949—416,615
Fiscal year ended June 30, 1950—591,568

Nearly all of this coal was used in making coke. Approximately 75 percent of the coal was shipped after washing with the remainder being shipped in an unwashed condition. (I-R. 41.)

The coal mined by taxpayer was, however, also suitable for non-coking (i.e., commercial) uses, and during the taxable years in question taxpayer sold a portion of the coal it extracted from its Sunnyside coal mine. Such sales were in competition with sales of coal not suitable for coking and were sold to the following purchasers in the amounts and at the prices stated (I-R. 42, 43):

For the Fiscal Year Ended June 30, 1949:

Purchaser	Net Tons	Price Per Net Ton
Columbia-Geneva Steel	16,913	$4.68
Permanente Metals	54	4.57
Utah Fuel Company	8,266	5.70
Denver & Rio Grande Western Ry. Co.	27	4.74
	25,260 [2]	

For the Fiscal Year Ended June 30, 1950:

Purchaser	Net Tons	Price Per Net Ton
Sugarhouse Coal Co.	58	$4.59
Kennecott Copper Co.	4,666	4.64
Columbia-Geneva Steel	19,729	5.00
Idaho-Portland Cement Co.	3,745	4.60
Denver & Rio Grande Western Ry. Co.	142	4.75
	28,340	

The weighted average sales price of these sales was $5.01 for the fiscal year 1949 and $4.89 for the fiscal year 1950. Taxpayer used these weighted average prices less royalties in determining its gross income from mining coal in order to compute its depletion allowance for the taxable years in question. (I-R. 43.) That is, on its income tax return for the taxable year 1949, taxpayer determined its depletion allowance with respect to its Sunnyside coal mine by using a

[2] There was also a transfer made by taxpayer to Kaiser-Frazer Parts in the amount of 75,744 tons. But, as this transfer was made at cost, it was not treated by the Court as being a sale. (I-R. 42.)

price of $4.6746 ($5.015 less $.3404 royalty) per net ton at the mine for its Sunnyside Coal (I-R. 41) and on its income tax return for the taxable year 1950 determined the same depletion allowance by using a price of $4.5414 ($4.88 less $.3386 royalty) per net ton at the mine (I-R. 42). However, in its claim for refund with respect to its taxable year 1949, taxpayer determined its depletion allowance on its Sunnyside coal mine by using a price of $9.5596 ($9.90 less $.3404 royalty) per net ton at the mine (I-R. 41-42) and in its claim for refund with respect to its taxable year 1950, taxpayer determined its depletion allowance on its Sunnyside coal mine by using a price of $8.5114 ($8.85 less $.3386 royalty) per net ton at the mine (I-R. 42).

Utah Fuel Company, the lessor of taxpayer's Sunnyside mine since 1942, was an independent company prior to 1950 which also operated coal properties at Sunnyside, Utah. The properties operated by Utah Fuel were adjacent to the mine leased and operated by taxpayer and was designated "Sunnyside # 1" while that operated by taxpayer was designated as "Sunnyside # 2." (I-R. 43.)

During the years in suit, and the years immediately prior thereto, there was only one washing facility at Sunnyside, Utah and, as both taxpayer and Utah Fuel desired washed coal, the washery was shared. In using the washery, coal mined by taxpayer was comingled with the coal mined by Utah Fuel. Thus, some of the coal that taxpayer sold and some of the coal which it used in its production facility was actually mined by Utah Fuel from the Sunnyside # 1

mine. (I-R. 43-44.) The Sunnyside coal mined by Utah Fuel had all the characteristics of the Sunnyside coal mined by taxpayer, the coals were interchangeable, were in fact interchanged, and were therefore coals of like kind and grade. (I-R. 44.)

Utah Fuel sold the coal that it mined on the open market. All or nearly all of the Sunnyside coal sold by it was used by the purchasers for heating purposes or for making of steam. During the calendar years 1946 through 1949, Utah Fuel sold the following tonnages of Sunnyside coal (I-R. 44):

Year	Net Tons Sold	Average Price Per Ton
1946	308,694.65	$3.40
1947	265,103.90	4.05
1948	281,167.40	4.80
1949	210,309.75	4.79

In addition, Utah Fuel sold 116,511.5 net tons at $4.51 per net ton during January, 1950, and 7,558.87 net tons at $4.31 per net ton during February, 1950. (I-R. 44.)[3]

Thus, the sales price obtained by Utah Fuel for Sunnyside coal sold at arm's length on the open market during the tax years in question together with the sales made by taxpayer for its Sunnyside coal during the same period established a representative market price for taxpayer's coal for the purpose of determin-

[3] Subsequently, taxpayer purchased the stock of Utah Fuel and for all periods thereafter had control over the Sunnyside #1 mine. Although other sales were made from Sunnyside mine #1 after taxpayer acquired Utah Fuel, no evidence of these sales was introduced at trial. (I-R. 44.)

ing its depletion allowance. The representative market price thus established was $4.75 per net ton for the fiscal year ended June 30, 1949 and $4.87 per net ton for the fiscal year ended June 30, 1950. (I-R. 45.)

In an attempt to compare coking coals from different sources, several factors must be considered. Among the factors to be considered are the amount of fixed carbon, volatile matter (gases), sulphur and ash that are contained in the coal as well as the plasticity of the coal, with the most important factor being the amount of the fixed carbon. It is the fixed carbon in the coal that iron manufacturers are purchasing when they buy coking coal for it is the fixed carbon which provides the fuel in the blast furnace. (I-R. 45.)

Volatile matter is the gaseous matter which is imprisoned in the coal and which is released when the coal is treated in a coke oven. Although the volatile matter is not deleterious, it must be removed in the coking process. (I-R. 45.)

In an attempt to classify coking coal by grade, the American Society for Testing Materials has prescribed the following guidelines based upon the relative amounts of fixed carbon and volatile matter (in terms of percentage of coal) that the coal contains (I-R. 46):

Coal grade	Percentage of Volatile matter	Percentage of Fixed Carbon
Low-Volatile	14 to 22	86 to 78
Medium-Volatile	22 to 31	78 to 69
High-Volatile	31 to 42	69 and below

Sulphur is a deleterious element in coking coal as well as in iron ore. Unless it is removed in the blast furnace by an industrial process (at additional expense to the manufacturer) it will contaminate the iron and steel and cause it to become brittle. (I-R. 46.)

Ash is the term used in the coking coal industry to describe the impurities in coal other than volatile matter, sulphur, and phosphorous. Some ash may be removed by washing the coal before it is processed into coke. The remaining ash must be removed in the blast furnace. Both of these processes increase a manufacturer's cost of production. (I-R. 46.)

During the years in suit, the Sunnyside coking coal mined by taxpayer and shipped to its production facilities had the following chemical analysis (I-R. 46):

Year	Percentage of Fixed carbon	Percentage of volatile matter	Percentage of ash	Sulphur	Water
1949	54.0	39.0	7.1	1.29	6.7
1950	53.7	39.5	6.8	1.12	7.0

The high-volatile coking coal (that coal which contains less than 69 percent fixed carbon) mined in the Western United States during the years in suit when processed alone in a coke oven produced coke that was physically weak and which tended to pulverize in a ferrous blast furnace. Therefore, it was not feasible to use this coking coal alone. On the other hand, low-volatile coal (that coal which contains more than 78 percent fixed carbon) cannot be used alone in the by-products oven because it tends to swell and would thereby damage the coking oven. Thus, the practice

during the years in issue was to blend a large portion of high-volatile coal with a small portion of low-volatile coal to arrive at a coke with optimum strength at the most economical cost. Low-volatile coals were therefore referred to as blending coals and all of the Western steel producers purchased substantial tonnages of low volatile coal from the mines in the Arkansas-Oklahoma region of the United States. However, the low-volatile coking coal produced in the Arkansas-Oklahoma area could not be used as a complete substitute for taxpayer's Sunnyside coal in the coke making process and therefore was not a mineral product of "like kind and grade" as that mined by taxpayer. (I-R. 46-47).

During the calendar years 1948, 1949 and 1950, the Colorado Fuel and Iron Company of Pueblo, Colorado purchased high-volatile coal from producers in the Raton Mesa area of New Mexico and Colorado for use in making coke. That coal was bought on the open market and the following is the weighted average price of this coal purchased in an unwashed condition (R. 47):

Year	Net Tons	Weighted Average Price f.o.b. mine
1948	640,843	$4.97
1949	441,253	5.24
1950	515,278	5.43

Nearly all of the coal purchased by Colorado Fuel and Iron Company during 1948, 1949 and 1950 was acquired from the St. Louis, Rocky Mountain and Pacific Company of Raton, New Mexico (hereinafter referred to as "Raton") from its Koehler mine. It was not acquired on a long-term contract basis. In

addition to the sales to Colorado Fuel and Iron Company, Raton sold the following tonnages of its Koehler coking coal to the following parties (I-R. 48):

dar Year	Tons	Purchaser	Price Per Ton
7	54,138	Sheffield Steel Corp.	$4.14-4.95
	600 (Approx.)	U.S. Marine Hosp., N. Mex.	5.42
	12,000	Raton Public Service Co.	4.25
	600	N. Mex. Industrial School	4.25
	500	Navajo Ord. Depot, Ariz.	4.70
	600/800	U.S. Post Office	4.70-5.75
	2,500	Nat'l. Sugar Mfg. Co.	4.25
	20,000	Govt purchases (export)	4.39
	Unknown	Reynolds Metal	4.39
	Unknown	Retail Coal dealers	Unknown
3	25,976	Sheffield Steel Corp.	4.95
	218,980	Santa Fe R.R.	5.10 (average)
	75,000 plus	Retail dealers	2.50-2.75
	2,500	N. Mex. Penitentiary	5.65
	66,361	Export	4.49-5.14
	600 (Approx.)	U.S. Marine Hosp., N. Mex.	5.42
	12,000 (Approx.)	Raton Public Service Co.	4.25
	600 (Approx.)	N. Mex. Industrial School	4.25
	500 (Approx.)	Navajo Ord. Depot, Ariz.	4.70
	600/800 (Approx.)	U.S. Post Office	4.70-5.75
)	29,754	Kaiser Steel	4.60
	109,019	Santa Fe R.R.	5.14 (average)
	50,000-75,000	Retail dealers	2.50-2.75
	2,500 (Approx.)	N. Mex. Penitentiary	5.65
	600 (Approx.)	U.S. Marine Hosp., N. Mex.	5.42
	12,000 (Approx.)	Raton Public Service Co.	4.25
	600 (Approx.)	N. Mex. Industrial School	4.25
	500 (Approx.)	Navajo Ord. Depot, Ariz.	4.70
	600/800 (Approx.)	U.S. Post Office	4.70-5.75
	39,524	Kaiser Steel	5.00-5.25
	55,272	Santa Fe R.R.	5.50 (average)
	50,000-75,000	Retail dealers	2.50-3.00
	2,500 (Approx.)	N. Mex. Penitentiary	5.65
	600 (Approx.)	U.S. Marine Hosp., N. Mex.	5.42
	600 (Approx.)	N. Mex. Industrial School	4.25
	500 (Approx.)	Navajo Ord. Depot, Ariz.	4.70
	600/800 (Approx.)	U.S. Post Office	4.70-4.75

During the years in question, the Koehler coking coal mined by Raton and shipped to Colorado Fuel and Iron Company had the following chemical analysis in terms of percentage of coal (I-R. 49):

Year	Percentage of fixed carbon	Percentage of Volatile matter	Percentage of Ash	Percentage of sulphur	Percentage of Water
1949	50.9	37.3	11.8	.78	6.7
1950	50.6	37.1	12.3	.75	6.0

In addition, the Koehler coking coal from Raton and taxpayer's Sunnyside coking coal were subjected to various tests to determine their relative plasticity. The plasticity of coal is a physical rather than a chemical charactertistic. When coking coal is processed in a coke oven, one of its constituent parts, vitrain, tends to melt and become a viscous liquid as the coal is heated. This liquid comes to the surface of the coke and in the process envelopes and permeates the forming coke. As the coke cools, the vitrain hardens to form a binder for the fixed carbon in the coke. A coking coal which contains more vitrain or whose vitrain flows more readily is described as having greater plasticity. Plasticity gives the coke physical strength so that it does not pulverize or break down in the blast furnace. Thus, the greater the plasticity of a given coal, the stronger is the coke that is made from this coal and the more desirable is the coal for coking purposes. The results of the plasticity tests show that Raton's Koehler coking coal had greater plasticity than taxpayer's Sunnyside coking coal and would therefore tend to form a stronger coke. (I-R. 49.)

Thus, a comparison of the coal mined by Raton from its Koehler mine with the coal mined by taxpayer from its Sunnyside mine shows that the Sunnyside coal contains more fixed carbon (premium) and more sulphur (penalty) while the Koehler coal has more ash (penalty) and greater plasticity (premium). Thus, the advantages of each coal over the other minimizes the competitive economic differences between them. (I-R. 50.)

The Koehler coal and the Sunnyside coal competed directly in the market place, were both suitable for the production of coke when blended with low volatile coal and were similarly utilized. Both coals were also extensively sold for non-coking purposes. They were mineral products of like kind and grade. (I-R. 50.)

The sales prices of the Koehler coal before, during and after the years in question confirms the fact that the sales prices obtained by Utah Fuel for its Sunnyside coal was representative of the market price for Sunnyside coal during the years involved. (I-R. 50.)

In its manufacturing operations, taxpayer used both iron ore that it mined from its own properties as well as iron ore which it purchased from other miners. Taxpayer's own iron ore mining properties were the Vulcan Mine in San Bernardino County, California and the Eagle Mountain Mine in Riverside County, California. (I-R. 33-34.)

During the years in suit, taxpayer mined and shipped to its production facilities the following tonnages (in net tons) of iron ore from its iron ore mining properties (I-R. 34):

Mine	Fiscal Year Ended June 30, 1949	Fiscal Year Ended June 30, 1950
Eagle Mountain	276,655	835,215
Vulcan	167,970	—

On its income tax return for the taxable year 1949, taxpayer determined its depletion allowance with respect to its iron ore mines by using a price of $2.89 per net ton of ore at the mine for its Eagle Mountain mine and a price of $3.13 per net ton of ore at its Vulcan mine. (I-R. 34.) And, on its income tax return for the taxable year 1950, taxpayer determined the same depletion allowance for its Eagle Mountain Mine by using a price of $3.5455 per net ton at the mine. (I-R. 35.) However, in its claim for refund with respect to its taxable year 1949, taxpayer determined its depletion allowance for its Eagle Mountain Mine by using a price of $3.584 per net ton at the mine for the period of July 1, 1948 through December 31, 1948 and $4.371 per net ton for the period of January 1, 1949 through June 30, 1949. And, for its Vulcan mine, it used a price of $4.263 per net ton at Kelso, California (nine miles from the mine) for the period of July 1, 1948 through December 31, 1948 and a price of $4.912 per net ton for the period of January 1, 1949 through June 30, 1949. (I-R. 34-35.) In addition, in its claim for refund with respect to its fiscal year 1950, taxpayer determined its depletion allowance for its Eagle Mountain mine by using a price of $4.903 per net ton at the mine for the period of July 1, 1949 through December 31, 1949, and $5.376 per net ton for the period of January 1, 1950 through June 30, 1950. (I-R. 35.)

During 1941, 1942, 1943, and early 1944, Utah Construction and Mining Company, formerly Utah Construction Company, was extracting iron ore on a contract basis for Colorado Fuel and Iron Company and for Mr. Senter Walker in the vicinity of Cedar City, Utah. On February 16, 1944, it assumed Mr. Walker's rights under a contract to purchase the property from which it was extracting ore. This property was known as the Iron Springs, Utah Mine. (I-R. 35.) Subsequently, on June 1, 1946, the Utah Construction and Mining Company entered into a contract to sell iron ore from the Iron Springs, Utah Mine to taxpayer. In the years prior to, during, and after the years in suit, Utah Construction and Mining Company sold substantial tonnages of iron ore to taxpayer. (I-R. 35-36.) Following is a schedule of the tonnages and the sales prices for these sales (I-R. 36):

Fiscal Year Ended	Net Tons	Price Per Ton f.o.b. Iron Springs, Utah
June 30, 1946	179,809	$1.688
June 30, 1947	447,178	2.037
June 30, 1948	381,103	2.037
June 30, 1949	146,501	1.869
June 30, 1950	228,924	1.901
June 30, 1951	376,858	2.11
June 30, 1952	297,982	2.95
June 30, 1953	178,618	4.49
June 30, 1954	165,693	4.72

During the years in suit (which are underlined), the ore that taxpayer purchased from the Iron Springs, Utah Mine constituted over 20 percent of the iron ore consumed by it in its production facilities. (I-R. 36.)

In addition, Utah Construction and Mining Com-

pany was, from 1946 on, (including the years in question), in the business of selling its iron ore to others. Following is a schedule of tonnages and sales prices for the sales made during its fiscal years ended October 31, 1948, 1949, and 1950 to its customers, including taxpayer (I-R. 36-37):

Fiscal Year Ending 10-31-48	Size	Net Tons	Per Ton f.o.b. Mine
Kaiser Company	2½″ Minus	266,627.34)	
	2½″x10″	18,273.50)	
Kaiser-Frazer Parts	2½″x5/8″	169,360.15)	$1.88
Kaiser Company for Lone		)	
Star Steel	10″ Minus	5,188.35)	
South Dakota Cement Plant	2½″ Minus	1,776.45	4.50
Ideal Cement Company	2½″ Minus	4,123.75	3.60
Lehigh Portland Cement	2½″ Minus	794.60	3.50
Atkins and Kroll	Misc.	248.10	5.13
Balfour Guthrie	Misc.	364.55	6.00
American Foundry & Machine	2½″x5/8″	124.20	6.00
Pacific Steel Company	2½″x5/8″	61.20	5.75
Anaconda	2½″x10″	52.65	6.25
Export Sales	10″ Minus	48,499.55	3.18
Total Tons		515,494.39	
Weighted Average f.o.b. Mine Price			$2.04

Fiscal Year Ending 10-31-49	Size	Net Tons	Per Ton f.o.b. Mine
Kaiser Company	2½″x10″	41,537.15)	
Kaiser Company	2½″ Minus	141,410.45)	
Kaiser-Fraser Parts	2½″x5/8″)	)	$2.18
Kaiser-Fraser Parts	5/8″ Minus)	145,849.80)	
Ideal Cement	2½″ Minus	6,089.35	3.96
Portland Cement	2½″ Minus	61.30	4.50
American Foundry & Machine	2½″x5/8″	122.95	6.23
Anaconda	2½″x10″	3,376.86	4.19
Balfour Guthrie	Misc.	73.05	6.25
Carnegie Illinois	2½″x10″	6,714 95	3.52
U.P.R.R. Claim	10″ Minus	61.00	4.02
International Smelter	2½″x5/8″	178.85	6 25
Export Sales	10″ Minus	39,181.55	3.78
Export Sales	10″ Minus	270,293.70	2.36
Total Tons		654,950.96	
Weighted Average f.o.b. Mine Price			$2.39

Fiscal Year Ending 10-31-50	Size	Net Tons	Per Ton f.o.b. Mine
Kaiser Company	2½″ Minus	183,094.10)	$2.36
Kaiser Company	2½″x10″	111,396.60	
Geneva Steel Company	2½″ Minus	371,380.50)	1.29
	2½″x5/8″	51,532.90)	
Carnegie Illinois	2½″x10″	54,044.23	3.57
Anaconda	2½″x10″	4,233.20	4.19
American Foundry & Machine	2½″x5/8″	121.55	6.25
International Smelting & Refining	2½″x5/8″	121.25	6.25
Ideal Cement Company	5/8″ Minus	1,772.65	4.00
Idaho Cement	5/8″ Minus	501.20	4.00
Oregon Cement	5/8″ Minus	991.80	4.00
Utah Portland Cement	5/8″ Minus	578.35	4.50
U.P.R.R. Claim	10″ Minus	63.20	4.00
Total Tons		779,831.53	
Weighted Average f.o.b. Mine Price			$1.88

In attempting to compare iron ore from various mines, a number of factors are considered in the iron and steel industry. Among these are the amount of iron contained in the ore (the Fe content), the amount of sulphur (S), phosphorous (P), silica (SiO_2) and other elements in the ore and the moisture content of the ore, i.e., whether it is wet or dry. Since the main purpose for obtaining iron ore is to extract the iron it contains, the most important factor of iron ore is the iron (Fe) which it contains. Thus, the iron ore becomes more valuable as the iron (Fe) content increases. (I-R. 37-38.) Sulphur and phosphorus on the other hand, are deleterious elements in iron ore. They contaminate the manufactured iron and as a result must be removed from the ore by various means prior to its introduction into the blast furnace or by addition of extra fluxing material into the furnace itself. These additional processes increase the

cost of the manufactured product, i.e., pig iron. (I-R. 38.)

The chemical analysis of the iron ore shipped by taxpayer (in the condition as shipped or "natural basis") from its mines during the years involved was approximately the following (I-R. 38):

Fiscal Year Ended	Content of Ore in Percentage					
	Fe	S	P	SiO_2	H_2O	Other[4]
Eagle Mountain						
June 30, 1949	53.11	.365	.109	8.06	3.2	7.53
June 30, 1950	53.07	.393	.085	8.15	3.1	7.51
Vulcan						
June 30, 1949	52.14	1.920	.049	6.33	1.0	9.77

The chemical analysis (natural basis or as shipped) of the iron ore that Utah Construction and Mining Company sold taxpayer during the years in suit was approximately as follows (I-R. 38-39):

	Content of Ore in Percentage					
Fiscal Year Ended	Fe	S	P	SiO_2	H_2O	Other
June 30, 1949	54.59	.031	.294	6.65	4.2	6.14
June 30, 1950	54.59	.031	.298	6.42	4.3	6.14

The iron ore sold by Utah Construction and Mining Company to its customers, including taxpayer, during the tax years in question was similar to taxpayer's Eagle Mountain and Vulcan iron ores in physical and chemical composition. In addition, all of these ores were used for the same purposes in commercial application. (I-R. 39.)

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[4] This includes Alumina (Al_2O_3), lime (C_aO), magnesia (M_gO), and manganese (Mn).

Iron ore mined in the Western United States was used in the iron and steel industry in blast furnaces and in open-hearth furnaces. In addition, it was used by cement companies. The ore used in open-hearth furnaces had to be in lump form in order to sink through the molten bath. On the other hand, the ore used in blast furnaces had to be crushed and screened to size and must not have contained too many "fines". During the years in suit, the price of the ore that Utah Construction and Mining Company sold taxpayer was the same whether it was destined for use in a blast furnace or in an open-hearth furnace. Except for the differences in the size of the lumps, these ores had the same physical and chemical characteristics. (I-R. 39.)

For the purpose of computing taxpayer's depletion allowance, the iron ore mined by Utah Construction and Mining Company, whether used in a blast furnace, in an open-hearth furnace, or by a cement company is a mineral product of like kind and grade to the ore mined by taxpayer from its Eagle Mountain and Vulcan Mines. (I-R. 39-40.)

Taxpayer purchased no iron ore that was mined in the Great Lakes region of the United States and sold or moved none of its iron ore in that region or at the lower Great Lakes ports. Nor, is there any evidence that any iron ore extracted in the Great Lakes region of the United States was sold and shipped to the Western United States, i.e., California, Oregon, Nevada, Arizona, Utah, Washington, or Idaho. (I-R. 40.)

As the Great Lakes region is remote from the area of taxpayer's operation and because of the absence of any sales or shipments of ores from that area to the area of taxpayer's operation, the Great Lakes area must be considered as an independent market insofar as taxpayer is concerned and sales within that independent market area had no economic effect upon taxpayer's market area. And, during the years involved in this action, the prices commanded by iron ore at the lower Great Lakes ports did not establish a national representative market price for iron ore and did not establish or effect the representative market price for either Eagle Mountain or Vulcan iron ore. (I-R. 40.)

The sales of iron ore by Utah Construction and Mining Company during the tax years in question to its various customers, including taxpayer, were arm's-length transactions in which ore moved in commerce in an area which included taxpayer's mines and therefore established a representative market price for iron ore mined and shipped by taxpayer from its Vulcan and Eagle Mountain Mines during the taxable years in question. (I-R. 40-41.)

The representative market price for the years in issue of the iron ore mined and shipped by taxpayer were as follows (I-R. 41):

For fiscal year ended June 30, 1949—$2.29 per net ton.

For fiscal year ended June 30, 1950—$2.03 per net ton.

On the basis of the above evidence, the District Court found, as stated above, that representative market or field prices existed for the coal and iron ore mined by taxpayer and that the representative field

or market price was lower than that claimed in the case of both minerals by the taxpayer in its claims for refund and in fact was lower than the amount which taxpayer claimed in its tax returns in each of the years for each of the minerals and which was allowed by the Commissioner. Accordingly, the District Court ordered that taxpayer take nothing by its complaint and that the complaint be dismissed with prejudice.

This appeal followed.

SUMMARY OF ARGUMENT

This is a mineral depletion case. Taxpayer is an integrated miner-manufacturer who mines coal and iron ore and uses them in manufacturing iron and steel products. It is undisputed that taxpayer is entitled to depletion only on its constructive income from the raw mineral products of its mining operations, and that this income must be determined, under governing Treasury Regulations, by reference to the representative market prices of mineral products of like kind and grade, before transportation. The question presented is whether the District Court correctly determined the representative market prices for taxpayer's coal and iron ore. This is a question of fact. In its detailed findings the District Court has carefully weighed the voluminous evidence of record, and its findings as to the representative market prices are sound.

With regard to taxpayer's coal, the District Court derived its representative market price from open market sales by taxpayer and another company of

coal mined from adjacent mines which had identical characteristics. With respect to taxpayer's iron ore, the court derived the representative market price from substantial sales of such ore in a competitive market embracing taxpayer's area. Taxpayer asserts that the sales data used in both cases is irrelevant, for a variety of reasons, and that constructive figures based on sales by other producers—in another area, in the case of the iron ore—should be used.

The Government submits that the sales data used by the District Court was clearly probative of representative market prices; that the court's findings as to such prices are amply warranted by the record; hence, that the judgment below should be affirmed.

ARGUMENT

The District Court Correctly Determined the Representative Market or Field Prices Which Constitute Taxpayer's Depletion Base for the Taxable Years Involved

A. *The statute, the Regulation and relevant decisions*

Section 23(m) of the Internal Revenue Code of 1939, Appendix, *infra*, provides that in computing net income there shall be allowed as a deduction, in the case of mines and other natural deposits, a reasonable allowance for depletion "according to the peculiar conditions in each case," and that in all cases the allowance shall be made under rules and regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. Section 114(b)(4)(A) of the 1939 Code, Appendix, *infra*, provides that the allowance for depletion under Section 23(m) shall

(with qualifications irrelevant here) be specified percentages of the "gross income from the property"—5 per cent in the case of coal and 15 per cent in the case of iron ore. For the purposes of these percentage allowances, Section 114(b)(4)(B), Appendix, *infra*, defines "gross income from the property" as "gross income from mining" and, in turn, defines "mining" as including—

> not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; * * * (iii) in the case of iron ore, * * * and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; * * *.

In short, depletable "gross income from mining" was defined as income from the "commercially marketable" product of "ordinary treatment processes normally applied by mine owners or operators". And the statute made it clear as to coal and iron ore, at least, that the "ordinary treatment processes" terminated with loading the raw mineral for shipment. However, the statute did not provide similar guidelines as to other minerals mined and used by integrated miner-manufacturers. A number of integrated producers in this latter category contended in the

courts that their finished manufactured products were the first "commercially marketable" products of their "ordinary treatment processes", and that they were entitled to depletion on their gross sales. The Supreme Court rejected this contention in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, a decision which established significant principles with respect to all integrated producers and their depletion allowances.

In *Cannelton*, the taxpayer mined fire clay and shale and manufactured them into sewer pipe and other vitrified products. It claimed the depletion allowance on its gross sales of the manufactured products, contending that these products were the first "commercially marketable" result of "ordinary treatment processes because it could not sell its raw mineral at a profit, given its underground method of mining. Rejecting this contention, the Court held that (p. 86) raw minerals are "commercially marketable" within the meaning of the statute when they are "ready for industrial use or consumption"—whether or not a taxpayer can sell them at a profit. The Court held further (p. 87):

> Ever since the first percentage depletion statute, the cut-off point where "gross income from mining" has stopped has been the same, i.e., where the ordinary miner shipped the product of his mine. * * * As we see it, the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned.

The Court also (p. 86) noted that there were substantial sales of the raw minerals involved, in Indiana (where taxpayer was located) and Kentucky, and characterized these sales as "conclusive proof that, when extracted from the mine, the fire clay and shale are in such a state that they are ready for industrial use or consumption—in short, they have passed the "mining" state on which the depletion principles operate." [5]

The specific methods by which "gross income from mining" shall be computed has been prescribed for many years by a regulatory provision which, as applicable to the taxable years here involved, was contained in Section 29.23(m)-1(f) of Treasury Regulations 111 (1939 Code), Appendix, *infra*. That section deals first with the simple situation where a miner sells his crude mineral in the immediate vicinity of the mine. In that situation, the miner's depletable income is his gross sales. Section 29.23(m)-1(f) continues—

> but if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market

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[5] It is settled, however, that the *Cannelton* principles apply even to a completely integrated industry where there are no sales of the raw mineral on the open market. *Riddell* v. *Monolith Cement Co.*, 371 U.S. 537; *United States* v. *Longhorn Portland Cement Co.*, 328 F. 2d 491 (C.A. 5th); *United States* v. *Light Aggregates, Inc.*, 343 F. 2d 429 (C.A. 8th). In such situations, as set forth in the text, the integrated producer's constructive "gross income from mining" is computed under the proportionate profits method prescribed by the same Regulation here involved.

> or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product.

Finally, the Regulation deals with situations where there is no representative market or field price for the raw mineral, i.e., where there is a largely integrated industry in which the crude mineral is generally not traded and sold because almost every member of the industry mines his own minerals and uses them in manufacturing the end product. In such situations, the Regulation prescribes the proportionate profits method of computing the integrated producer's constructive "gross income from mining."

This Regulation has been in force with few substantive changes since 1940, when it was added to Treasury Regulations 101 under the Revenue Act of 1939 by Treasury Decision 4960, 1940-1 Cum. Bull. 38, and promulgated as Section 19.23(m)-1(f) of Treasury Regulations 103 under the 1939 Code. It is currently in force as Section 39.23(m)-1(e)(3) of Treasury Regulations 118 (1939 Code) which is applicable under the 1954 Code until superseded by new Regulations. (See Section 7807 of the 1954 Code.)

In the depletion area, the broad statutory delegation of regulatory powers reflects recognition by Congress that it "could not forsee the multifarious circumstances which would involve questions of depletion." *Douglas* v. *Commissioner*, 322 U.S. 275, 281. Moreover, "the highly technical and involved factors entering into a practical solution of the problem of depletion in administration of the tax laws points to

the necessity of interpreting * * * (the applicable statute) so as to strengthen rather than weaken the administrative powers to deal with it equitably and reasonably." *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 103, rehearing denied, 308 U.S. 638. No court has ever questioned the validity of the long-standing Regulation involved in the instant case, and a taxpayer challenging one of the prescribed methods of computation has a heavy burden indeed. *United States* v. *Portland Cement Co. of Utah*, 378 F. 2d 91 (C.A. 10th).

In the instant case, it is undisputed that taxpayer's depletable "gross income from mining" must be computed constructively under the second method prescribed by the Regulation, i.e., by reference to "the representative market or field price * * * of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product." The basic criteria for application of this method are clear. Under the statute, percentage depletion is allowed on *gross income* from *mining*. As the Supreme Court said in *Cannelton* (364 U.S. at p. 87), the cut-off point on such depletable income is "where the ordinary miner shipped the product of his mine," and the integrated producer's (p. 86) "constructive income from the raw mineral product" must be computed at that cut-off point, treating the producer as selling his crude mineral to himself.

Accordingly, a "representative market or field price" must be a price actually charged by a miner for his raw mineral, before transportation, as reflect-

ed in actual sales. Other figures, such as projected market value, value to the owner or replacement value, will not do. Actual sales data is essential to establish the existence of a relevant market and, if it exists, the representative or typical price in that market. If there is a market and a representative price for an integrated producer's raw mineral (or a comparable mineral), they control the computation of his constructive mining income.[6]

In *United States Pipe & Foundry Co.* v. *Patterson*, 203 F. Supp. 335 (N.D. Ala.), the court said (p. 348):

> The search in these coal depletion cases is for market price, not for market value. Where the owner establishes a representative market price for its coal by selling substantial quantities in the market, affected by competitive bargaining and principles of supply and demand, it is entitled to the benefit thereof in computing percentage depletion on all of the coal mined by it during such year. On the other hand, if it elects to exercise its undoubted right to retain all of the coal it mines for use in its integrated manufacturing processes because its intrinsic characteristics impart some added value in the uses to which it is put, this court is of the firm opinion that the best evidence of its representative market price is the weighted average prices of all

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[6] The computation is made by multiplying the representative price by the number of units mined by the integrated producer. This is the so-called "market comparison" method. See *Woodward Iron Co.* v. *Patterson*, 173 F. Supp. 251, 268 (N.D. Ala.); *Hugoton Production Co.* v. *United States*, 315 F. 2d 868, 870 (Ct. Cl.).

> coal of like kind and grade sold in the district during the year involved. * * *

And, as stated by the Fifth Circuit in *Shamrock Oil & Gas Corp.* v. *Coffee*, 140 F. 2d 409, 410-411:

> Market price is the price that is actually paid by buyers for the same commodity in the same market. It is not necessarily the same as "market value" or "fair market value" or "reasonable worth." * * * Opinions and estimates, and particularly consideration of what the buyers could have paid or should have paid, are entirely irrelevant.

It should be noted that the character of a particular market does not affect the "representativeness" of prices established in that market. A market price may be representative (or typical) of that market regardless of whether the market is a "thin" market or a "fat" market; whether it is a "buyer's" market or a "seller's" market.[7] There is no warrant in the Regulation or relevant decisions for giving any special meaning to the term "market," as by limiting it to some defined level of competition or minimum number of buyers. To the contrary, in *Alabama By-Products Corp.* v. *Patterson*, 258 F. 2d 892, 899 (C.A. 5th), certiorari denied, 358 U.S. 930, the court

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[7] For example, Mr. Heiner, formerly president of Utah Fuel, characterized the market for Sunnyside coal as a "buyer's" market (II-R. 333) and Mr. Carrier, an economist, described the market for Utah iron ore during the years in question as a "thin market" (II-R. 639-640). Regardless of whether it was a "thin" market or a "buyer's" market or any other type of market, taxpayer's gross income from mining is to be determined on the basis of the representative market or field price resulting therefrom.

cited with approval the ruling in *Riverton Lime and Stone Co.* v. *Commissioner*, 28 T.C. 446, that even a small declining market can establish a representative price. And taxpayer itself asserts (Br. 51-54) that the representative price for its coal was established by transactions between one buyer and one seller.

As for what constitutes "of a mineral of like kind and grade" in *United States* v. *Henderson Clay Products*, 324 F. 2d 7, 11 (C.A. 5th), certiorari denied, 377 U.S. 917, the court said in reaffirming its holding in *Alabama By-Products* v. *Patterson, supra*:

> The Alabama By-Products holding was that minerals are of like kind and grade if they are substantially equivalent by commercial standards. Physical, chemical, or geological differences have importance only if they give rise to differences in commercial competition. (Citations omitted) Moreover, the question is not whether the products were actually used for the same commercial purpose but rather whether they *could* have been so used.

B. ***The nature and background of the questions presented***

This Court held in *Ames* v. *United States*, 330 F. 2d 770, 773:

> Representative market price is a question of fact. See Hugoton Prod. Co. v. United States, Ct. Cl., 315 F. 2d 868, 877. The trial court's finding thereon is not to be set aside unless clearly erroneous and this rule applies not only to the determination of basic facts, but also to factual inferences from undisputed basic facts. Commissioner v. Duberstein, 363 U.S. 278, 291.

Truck Terminals, Inc. v. Commissioner, 9 Cir., 314 F. 2d 449, 455.

Taxpayer has candidly acknowledged (Br. 19) the factual nature of the question, citing *Ames*, and has attempted to show that the findings of the District Court are "clearly erroneous". However, it may be noted that taxpayer itself has been beset with continuing doubts along the way as to the representative market prices for its minerals. The representative prices used by taxpayer and the depletion allowances claimed in its returns for the taxable years, as originally filed, were accepted by the Commissioner with relatively minor adjustments. (I-R. 32.) Thereafter, however, in the claims for refund on which this litigation is based, taxpayer claimed substantially higher depletion allowances on the basis of different representative prices. (I-R. 32-35, 41-42.) And, as detailed below, taxpayer has continued to change its position from time to time during this litigation, with respect to the amount and derivation of representative prices.

It is abundantly evident from the District Court's detailed findings that it has carefully sifted and weighed the voluminous evidence of record. We submit that its analysis of the evidence supports its specific and unqualified findings as to the representative market prices for the taxpayer's minerals during the taxable years involved.

C. *The record amply warrants the District Court's finding that the sales prices obtained by taxpayer and Utah Fuel Company for coal from their adjacent Sunnyside mines, during the taxable years, established the representative market price for taxpayer's coal*

Sales data in three categories were introduced in evidence and considered by the District Court with respect to a representative market or field price for the coking coal mined by taxpayer from its Sunnyside mine during the taxable years: (1) Taxpayer's sales of its Sunnyside coal during the years in suit; (2) Sales by Utah Fuel Company of coking coal from its adjacent Sunnyside mine; and (3) Sales of Raton-Mesa coking coal by the St. Louis, Rocky Mountain & Pacific Company and other companies mining in the Raton-Mesa area of Colorado and New Mexico during 1948, 1949 and 1950.

The District Court found (I-R. 43-44) that the coal mined by taxpayer and Utah Fuel, respectively, from their adjacent Sunnyside mines were of like kind and grade since they had the same characteristics, were interchangeable, and in fact were commingled and exchanged in a common washery. The court further found (I-R. 44-45) that the sales prices obtained for their Sunnyside coal by taxpayer and Utah Fuel, respectively, reflected arm's length sales on the open market, and together (by weighed average) established a representative market price for the taxpayer's coal. Finally, the court found (I-R. 50) that this representative price was confirmed by data as to sales, in the same market and at similar prices, of Raton-Mesa coal with competitive characteristics.

As shown below, the court's analysis of the pertinent sales data of record was sound and fully supports its finding as to the representative market price.

1. *Sales of Sunnyside coal by Utah Fuel Company*

Prior to and during the years in suit, Utah Coal was an independent mining and merchandising company which owned adjoining mines at Sunnyside. It operated one mine itself and leased the other to the instant taxpayer. The coal in these two mines had the same characteristics, were interchangeable, and in fact were commingled and interchanged in the common washery used by Utah Fuel and taxpayer. (I-R. 43-44.)

During the years 1946 through 1949 Utah Fuel sold substantial net tonnages of its Sunnyside coal on the open market, mostly for heating purposes or making steam. In round figures the tonnages ranged from 309,000 for 1946 to 210,000 in 1949. During the first two months of 1950 Utah Fuel sold 124,000 net tons. In early 1950, taxpayer purchased the stock of Utah Fuel and thereafter controlled the mine Utah Fuel had operated. (I-R. 44.)

Utah Fuel's average sales prices per net ton for 1948 and 1949, respectively, were \$4.80 and \$4.79. (I-R. 44.) The average prices obtained by taxpayer for its Sunnyside coal during the fiscal years in suit (ended June 30, 1949, and June 30, 1950) were \$5.01 and \$4.89 per net ton. The close parallel in prices was no accident; in many instances during 1949 and early 1950 taxpayer priced its own coal by reference

to Utah Fuel's prices. (II-R. 115, 116, 120, 126.) Mr. Heers, taxpayer's Manager of Mines and Raw Materials, testified that (II-R, 115):

> The prices that we used, we simply followed the pattern of those that were established by the Utah Fuel Company, who were in the commercial coal business. Some of these sales were taken at the request of Utah Fuel Company to supply their regular customers in instances where the Utah Fuel Company's regular No. 1 mine didn't have enough production * * *.

In short, taxpayer recognized and accepted Utah Fuel's prices as the going market price for the Sunnyside coal.

Taxpayer now urges, nevertheless, that the District Court erred in taking Utah Fuel's sales into account because (Br. 48-49) they were "sales made under peculiar economic conditions and, in effect, distress sales," and that until 1949 these sales were "made at less than cost." This argument is specious and unsound.

To be sure, distress sales at sacrifice prices are unlikely to be representative or typical market prices. More particularly, if a miner produces only one mineral from one mine and sells it below cost—a situation unlikely to continue for any length of time—the price will probably not be representative of prices charged by less irrational producers intent on a profit. But even this is not always the case; in *Cannelton* the taxpayer could not make a profit selling its fire clay and shale at the prices charged by its profit-making competitors because of the high cost of its under ground method of mining.

In any event, an entirely different situation is presented where a producer has diversified operations, only one of which is mining and selling raw minerals, and is making a tidy overall profit on its operations. In such a situation, notwithstanding the overall profit, the sales of raw minerals may be recorded in the taxpayer's books as below cost by reason of allocation of overhead and other accounting practices which the taxpayer has adopted, for a variety of reasons. It does not necessarily follow that the sales of raw minerals contribute to the taxpayer's overall profit—any more than it follows with respect to the sale of bagged cement by a producer who also sells in bulk, simply because the premium for bagged cement is less than the costs of bagging. See *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F. 2d 468, 474 (C.A. 3d).

Whitehall suggests other considerations. Sales of raw minerals by a diversified producer may, for example, be an accommodation to customers who purchase his other products, or a sales inducement to other customers to purchase minerals he cannot use in his other operations. Whatever the considerations involved, and whatever the bookkeeping legerdemain, the very fact that a prosperous producer continues to sell raw minerals year after year is a sure indication that, directly or indirectly, such sales contribute to his overall profit. The producer must have an overall profit incentive to meet the market prices for raw minerals charged by his competitors, even if his costs of mining are considerably higher than theirs. And

in meeting the competition he is, of course, adopting a representative market price.[8]

In the instant case taxpayer would have it that Utah Fuel was forced to make distress sales of its Sunnyside coal chronically over a twenty-year period, including the years 1946 through 1948. This assertion is refuted by the record. Utah Fuel was certainly not in a condition of financial distress, requiring sacrifice below-cost sales, during the years pertinent here. That company's income statements (Deft. Exs. AA and BB) reveal that it had the following net income for the years 1946 through 1949:

	Net Income (Before taxes)	Net Income (To surplus)
1946	$256,520	$192,380
1947	739,893	524,648
1948	465,162	251,540
1949	185,627	72,764

In addition, it had the following earned surpluses during these years:

	Earned Surplus for the year	Total Earned Surplus (Dec. 31st)
1946	$168,486	$4,687,975
1947	522,999	5,210,974
1948	368,567	5,579,541
1949	732,240	5,652,782

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[8] As noted above, merely because it was a "buyer's market" as Mr. Heiner described the coal market in Utah in those years (II-R. 333) does not prevent the sales prices of a mineral from establishing a "representative market price." See *Shamrock Oil & Gas Corp.* v. *Coffee, supra,* pp. 410-411.

Quite obviously, Utah Fuel was not in a distressed financial condition; its overall operations were prosperous and it was therefore under no economic compulsion to unload its Sunnyside coal at sacrifice prices unrelated to the going market price.

The fact that Utah Fuel's books showed a loss on Sunnyside sales during several of these years is misleading. This appears from Mr. Heiner's testimony with respect to the company's contract with Kaiser-Frazer Parts Corporation, in which the price for Sunnyside coal was fixed at $4.50 per net ton. (Pltf. Ex. 20.) Mr. Heiner, the president of Utah Fuel, made it clear that Utah Fuel profited from the contract because the price received was greater than the company's direct mining costs, although less than the direct costs plus allocated overhead. (II-R. 339-341.) The reason is evident. Since the overhead would have to be paid, regardless of the volume of sales, Utah Fuel was better off financially for having made the sales to Kaiser-Frazer. And with enough sales at $4.50 a ton, it might have made a substantial profit on these sales, regardless of overhead allocations.

Significantly, taxpayer mentions only in passing the profits realized by Utah Fuel from sales of Sunnyside coal during 1949. Of all the years involving such sales, 1949 is the most important since it encompasses six months of each of taxpayer's fiscal years in suit. The record shows that Utah Fuel made a clear profit of 11 cents per net ton on its sales during 1949. (II-R. 417.) It may be that the sales prices were not as high as Mr. Heiner and Utah Fuel would have liked them to be, but the evidence indicates that

the prices were necessarily adopted to meet open and free competition in the market. And precisely for that reason, Utah Fuel's prices reflected the typical or representative market prices. In the language of *Alabama By-Products Corp.* v. *Patterson*, 258 F. 2d 892, 899-900 (C.A. 5th):

> Although the sales made by the taxpayer were in the nature of "forced" sales owing to peculiar economic conditions, the sales of coking coal by the other companies were the natural result of competitive bargaining, and principles of supply and demand. This is enough to create a true market in commerce. Helvering v. Walbridge, 2 Cir., 1934, 70 F. 2d 683; Heinver v. Crosby, 3 Cir., 1928, 24 F. 2d 191.

Next, taxpayer contends that Utah Fuel's sales prices for its Sunnyside coal were irrelevant because they were sold for uses other than making coke, which is the use taxpayer's coal was sold for. But the courts have not attached importance to a distinction based upon the actual use of minerals by purchaser; whether one mineral is of "like kind and grade" with another depends upon its characteristics and potential use. As the Fifth Circuit said in *United States* v. *Henderson Clay Products*, *supra*, p. 11, "minerals are of like kind and grade if they are substantially equivalent by commercial standards. * * * the question is not whether the products were actually used for the same commercial purpose but rather whether they *could* have been so used." Thus in *United States Pipe & Foundry Co.* v. *Patterson*, *supra*, the District Court relied on sales of coking coal for non

coking uses to arrive at a representative market price for the taxpayer's coking coal, as did the District Court in *Alabama By-Products Corp.* v. *Patterson*, 151 F. Supp. 641. In affirming the latter decision the Fifth Circuit said in part (258 F. 2d 898-899):

> The District Court concluded that all bituminous coals in the Alabama fields are of like grade if commercially suitable for use in the manufacture of coke generally, regardless of the taxpayer's particular needs. To go further and classify coking coals according to their myriad of actual uses would lead to an unworkable system of grading coal, since the requirements of coke users vary so greatly. There would never be in the case of coking coal, a "mineral product of like kind and grade"; we would have a phrase without meaning.

In essence, taxpayer argues that it is entitled to additional depletion because its coal has more value when it is sold for coking coal than it has when it is sold for commercial purposes, in competition with ordinary coal. Aside from the fact that depletion is not computed on value, taxpayer's argument is unsound on several counts. First, if taxpayer's coal could in fact command a higher price when sold for coking purposes, it would have been sold as such and not at lower prices for commercial purposes. But both taxpayer and Utah Fuel sold Sunnyside coking coal for commercial purposes. (I-R. 42, 44.) Second, the evidence offered at trial in fact linked the purchase of Sunnyside coal for coking purposes to the price

which the seller received for its coal sold for *commercial* purposes.[9]

Suppose Utah Fuel and taxpayer decided to charge a premium price for Sunnyside coal because of its coking qualities; a potential buyer could easily turn to other sources of supply. For example, the St. Louis, Rocky Mountain & Pacific Company was selling its Raton-Mesa coal on the open market (II-R. 218-219) and there were several companies in the Trinidad, Colorado area (Deft. Ex. H) as well as in the Durango, Colorado (II-R. 310) and the Socorro, New Mexico area (II-R. 230) which were selling coking coal. With these alternative sources, a potential buyer would hardly be likely to pay a premium price for Sunnyside coal. There were simply too many miners of coking coal willing to sell and to sell at competitive commercial prices.

In the instant case the District Court found (I-R. 44) that the Sunnyside coal mined by Utah Fuel and taxpayer, respectively, had identical characteristics and were in fact interchanged in usage, and hence were coals "of like kind and grade". These producers sold their coal on the open market, in the same

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[9] In paragraph 9 of the lease between taxpayer and Utah Fuel covering taxpayer's lease of Sunnyside Mine # 2 (Pltf. Ex. 32), taxpayer was given the right for one year to purchase Sunnyside Mine # 1 coal at the commercial prices which Utah Fuel then received. And, in the contract dated January 29, 1948, between Utah Fuel and Kaiser-Frazer (Pltf. Ex. 20, par. VII), where a price of $4.50 per ton for Sunnyside coal was arrived at by negotiation (II-R. 339), Kaiser-Frazer was given the right to purchase Sunnyside coal at any more favorable price which Utah Fuel granted to any of its commercial customers.

area, for similar prices, and the District Court was clearly justified in taking Utah Fuel's prices into account in determining the representative market price for taxpayer's coal.

2. *Taxpayer's sales of Sunnyside coal*

During the fiscal years in suit, taxpayer sold the following net tonnages of its Sunnyside coal on the open market (as the District Court found) at the indicated weighted average prices per net ton:

Fiscal year	Net tons sold	Average price per ton
1949	25,260	$5.01
1950	28,340	4.89

Taxpayer contends in the first instance, that these sales were not indicative of a representative market price because they were "accommodation transfers". (Br. 50). It is true that the sales were so labeled in the testimony of Mr. Heers, taxpayer's Manager of Mines and Raw Materials; but there is no indication whatsoever in Mr. Heers' testimony (II-R. 94-101) that—apart from taxpayer's sales to Kaiser-Frazer Parts—taxpayer was ever willing to sell its Sunnyside coal, or ever did sell it, for less than the going market price.

In this connection, it may be noted that, during the four fiscal years following the years in suit, taxpayer continued to sell its Sunnyside coal at average prices per net ton (ranging from $5.14 to $4.83) which were very close to its average prices during the taxable years. And it sold very substantial tonnages at such

prices during fiscal 1951 and 1952—227,085 tons during fiscal 1951 and 311,208 tons during fiscal 1952. (Deft. Ex. II.) We submit that the history of taxpayer's market sales over the six fiscal years 1949-1954—given the relatively small fluctuation in its prices between \$5.14 and \$4.83 and the large tonnages sold in at least two of those years—is incompatible, to say the least, with its assertion that it sold its coal during the years in suit at "accommodation" prices unrelated to the going market price.

Taxpayer itself originally regarded its sales prices during the taxable years as representative market prices; it used weighted average prices based on its own sales (excluding a sale at cost to Kaiser-Frazer Parts) in computing its depletion allowances. (I-R. 42-43.) Taxpayer's subsequent changes of position were unwarranted.[10] There is no evidence whatever in the record that coking coal of the Sunnyside type was sold in the West during the taxable years at the prices which taxpayer now contends were representative. To the contrary, as appears below, all the evidence of contemporary sales of such coal confirms taxpayer's initial view (in which the Commissioner concurred) that its own prices were reasonably representative or typical of the going market price.

[10] The record indicates that taxpayer has relied on a variety of formulas and sales data at different times during this proceeding, including Connellsville, Pennsylvania, coke prices (Deft. Ex. U), an "imputed" coal price derived from certain undisclosed formulas (II-R. 427-485), Raton-Mesa coal prices with "recognized adjustments" (Br. 51-58), and a weighted average of low-volatile Arkansas-Oklahoma blending coal (Br. 58-62).

3. *Sales of Raton-Mesa coal from the Koehler mine*

High-volatile coking coal is defined as coking coal containing less than 69 per cent fixed carbon and 31 to 42 per cent volatile matter. (I-R. 46.) During the taxable years the St. Louis, Rocky Mountain & Pacific Company of Raton, New Mexico (hereinafter "Raton") sold on the open market very substantial tonnages of high-volatile coking coal from its Koehler mine, which was located in the Raton-Mesa area of New Mexico and Colorado. Raton supplied from its Koehler mine nearly all of the 1,597,374 net tons of Raton-Mesa high-volatile coking coal purchased in the open market by the Colorado Fuel and Iron Company of Pueblo, Colorado, during the three calendar years (1948-1950) which overlapped the fiscal years in suit. Colorado Fuel paid a weighted average price f.o.b. the mine of $4.97 in 1948, $5.24 in 1949, and $5.43 in 1950. Additionally, during the calendar years 1947-1950, Raton sold varying tonnages of Koehler coal to many other purchasers—including the instant taxpayer. These sales (which were not on a long-term contract basis) reflect prices per ton ranging from a low of $2.50 in each of the years (on sales to retail dealers) to a high in 1948, 1949, and 1950 of $5.65 on sales to the New Mexico Penitentiary. Most of the sales were made at prices under $5. (I-R. 47-48.)

The Koehler high-volatile coking coal differed somewhat from the Sunnyside high-volatile coking coal in composition and characteristics, with differing advantages and disadvantages. (I-R. 46, 49.) However, the District Court found that the advantages of

each coal over the other minimized the competitive economic differences between them; that both were suitable for production of coke when blended with low-volatile coal; and hence that they were minerals of like kind and grade. The court further found that Koehler coal and Sunnyside coal competed directly in the same market, where they were sold for production of coke and also "extensively sold" for non-coking purposes. (I-R. 50.)

Given these findings on market competition, together with the data as to sales prices of Koehler coal set forth in detail in earlier findings (I-R. 47-48), the District Court found as an ultimate fact (I-R. 50) that the Koehler prices confirmed the representative market prices of Sunnyside coal as reflected in Utah Fuel's prices for such coal. We submit that the record amply warrants the findings with respect to the Koehler coal and sales prices therefor.

Taxpayer concedes (Br. 53) the correctness of the District Court's findings that Raton-Mesa and Sunnyside coal competed directly in the same market, were both suitable for production of coke when blended with low-volatile coal and were similarly utilized. However, it contends (Br. 52-54) that only the sales of Raton-Mesa coal from the Koehler mine to Colorado Fuel, for coking purposes, were indicative of a representative market price for its Sunnyside coal. Taxpayer asserts (Br. 52) that these sales to Colorado Fuel were (apart from small sales to the same purchaser by other Raton-Mesa producers) "the only sales of high volatile coking coal in the West for coking purposes * * * and the only sales of coking coal

for any purpose which were made in the course of competitive transactions". It dismisses (Br. 53-54) the sales of Koehler coal for non-coking purposes as nonrepresentative, both by reason of end use and on the asserted ground that (apart from the sales to Sante Fe) "the sales were in small amounts and were entirely for steam or domestic purposes". These assertions are contrary to the record and the findings of the District Court and, in any case, do not support the dollar figure which taxpayer now contends was the representative market price.

First, the facts. Raton did indeed sell very substantial tonnages of Koehler coal to Colorado Fuel; they constituted nearly all of the 1,600,000 tons of Raton-Mesa coal purchased by Colorado Fuel over the three calendar years 1948-1950. (I-R. 47-48.) But Raton's sales of Koehler coal to other purchasers during the same years were also substantial, totaling in excess of 800,000 tons. Moreover, one of the largest purchasers in this group was the instant taxpayer, who purchased approximately 70,000 tons of Koehler coal during the two years 1949-1950. (I-R. 38.) In view of its own substantial purchases, taxpayer would appear to be inaccurate in its assertions that only the sales to Colorado Fuel were for coking purposes, and that sales of Koehler coal to other purchasers were entirely for heating or making steam.[11]

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[11] Taxpayer asserted on brief in the District Court that it purchased the Koehler coal to test its quality. Presumably, taxpayer tested the 70,000 tons by using it to produce coke which, in turn, was used in taxpayer's blast furnace operations. The record also shows that Koehler coal was sold for test coking

Taxpayer is similarly inaccurate in asserting that the sales of Koehler coal to Colorado Fuel were the only sales in the West of coking coal, for whatever purpose, which were made in competitive transactions. The District Court found that both taxpayer and Utah Fuel sold their Sunnyside coal at arm's-length on the open market. (I-R. 42-44.) It also found that the Raton-Mesa coal and the Sunnyside coal competed directly in the same market, and were sold extensively in that market for non-coking uses as well as production of coke. (I-R. 50.) Additionally, the court noted that sales of Koehler coal to purchasers other than Colorado Fuel were not sold on a long-term contract basis. (I-R. 49.) These findings, in relation to Koehler coal, are underscored by the testimony of Mr. Kastler, who was Raton's vice-president during the taxable years. (II-R. 179.) Mr. Kastler testified with respect to the Koehler coal (II-R. 184):

> Well, we were selling some to the Santa Fe Rairoad, some to government installations such as government hospitals, and to some retail dealers, some power plants, C. F. & I. (Colorado Fuel). In fact, I think we tried to sell to whoever would want to buy at that time.

With regard to how the prices were fixed on the sales to Kaiser, Mr. Kastler testified (II-R. 201): "By negotiation, I would say. We would try to figure out about what price they might be paying their other source of supply".

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purposes to the Lone Star Steel Corporation, the Sheffield Steel Corporation and U.S. Steel, Columbia-Geneva. (II-R. 197-199.)

In sum, it is clear that Raton's sales of Koehler coal to purchasers other than Colorado Fuel were substantial by any standard and were competitively negotiated in the open market—a market in which Koehler coal was in direct competition with Sunnyside coal as a mineral of "like kind and grade". Accordingly, these sales of Koehler coal, as well as the sales to Colorado Fuel were propertly taken into account by the District Court in reaching its ultimate finding that Koehler prices confirmed the representative character of Utah Fuel prices.

As for the taxpayer's contention that sales of Koehler coal for non-coking uses are irrelevant, we have already dealt with that "end use" argument as raised by taxpayer with respect to Utah Fuel's sales of Sunnyside coal. If one mineral has the same potential uses as another, it is a mineral of "like kind and grade", and its sales are probative of a representative market price. *United States* v. *Henderson Clay Products, supra; Alabama By-Products Corp.* v. *Patterson, supra; United States Pipe & Foundry Co.* v. *Patterson, supra.* As the Fifth Circuit said in *Alabama By-Products Corp.*, 258 F. 2d at pp. 898-899: "To * * * classify coking coals according to their myriad of actual uses would lead to an unworkable system of grading coal * * *. There would never be in the case of coking coal, a 'mineral product of like kind and grade'; we would have a phrase without a meaning".

Finally, taxpayer would not be entitled to the relief sought in this litigation even if, as it contends (Br. 54), the sales to Colorado Fuel alone were the "sig-

nificant sales * * * which establish a representative market price". In its complaint, as in its claims for refund, taxpayer claimed depletion allowances for its fiscal years 1949 and 1950 based on representative market prices of $9.90 and $8.85 per ton, respectively. (I-R. 41-42.) On appeal, taxpayer has scaled these figures down to $6.585 and $6.933. (Br. 57-58.) But the average prices at which Koehler coal was sold to Colorado Fuel during the calendar years 1948 through 1950 were $4.97, $5.24 and $5.43, respectively (I-R. 47)—or an average for 1948-1949 of $5.105 and for 1949-1950 of $5.335. The figures claimed by taxpayer are nearly 30 per cent higher than the latter averages. And this is without taking into account the sales of Koehler coal for coking purposes to purchasers other than Colorado Fuel—including the sale of 70,000 tons to taxpayer itself, competitively negotiated, according to Mr. Kastler of Raton (II-R. 184) and averaging only $4.60 for 1949 and $5-$5.25 for 1950 (I-R. 49).

By contrast, the representative market prices for the years in suit as found by the District Court ($4.75 and $4.87 (I-R. 45)) are only 7 per cent and 8 per cent less, respectively, than the average prices paid by Colorado Fuel for 1948-1949 and 1949-1950.

Taxpayer seeks to bridge the substantial gap between the prices paid by Colorado Fuel and its claimed representative prices by "adjustments" which it asserts (Br. 55-58) must be made to account for the "undesirable" ash content in Koehler coal and the fact that such coal was sold in an unwashed condition. Taxpayer cites only *United States* v. *Henderson Clay*

Products, *supra*, as authority for such "adjustments" in determining a representative market price by reference to sales of minerals of "like kind and grade", and—as is evident from the very language quoted from that decision by taxpayer (Br. 57)—*Henderson Clay Products* is wide of the mark. That case states that (324 F. 2d at p. 11): "Physical, chemical and geological differences have importance only if they give rise to differences in commercial competition". In the instant case the District Court, after discussing ash content, washing and plasticity, found that (I-R. 50):

> Comparison of the coal mined by Raton from the Koehler mine with the Sunnyside coal shipped by plaintiff shows that the Sunnyside coal contains more fixed carbon (premium) and more sulphur (penalty) than the Raton coal. On the other hand, the Raton coal has more ash (penalty) while having more plasticity (premium) than the Sunnyside coal. The advantages of each coal over the other minimize the competitive economic differences between them.

Taxpayer acknowledges (Br. 58), in effect, that a sulphur content of over 1 per cent "becomes troublesome in the blast furnace process". The "troublesome" consequence, brittle steel which fractures easily, may only be offset by expensive processes. (II-R. 968-970.) Taxpayer's Sunnyside coal contained 1.29 per cent of sulphur in 1949 and 1.12 per cent in 1950, whereas Raton coal contained only .78 per cent and .75 per cent, respectively, in those years. (I-R. 46-49.) Taxpayer errs in arguing that the record

discloses no basis for regarding sulphur content as a detriment reflected in pricing. Taxpayer's own Manager of Mines and Raw Materials testified (II-R. 92) that, for each one-tenth of one percent of sulphur content, there is a value difference of from 5 to 10 cents per ton and that such adjustments were made in purchasing and selling coal. Thus, in the coke contract between Utah Fuel and American Smelting & Refining, provision was made for a penalty of excessive sulphur. (Deft. Ex. EE, par. V.)

Taxpayer is similarly in error in its assertion (Br. 58) that differences in plasticity are immaterial. The District Court found that (I-R. 49): "Plasticity gives the coke physical strength so that it does not pulverize or break down in the blast furnace", and "the stronger the coke * * * the more desirable the coal for coking purposes". The court further found that (I-R. 49) the results of all three tests of plasticity showed that "the Raton coal has greater plasticity than plaintiff's Sunnyside coal and would, consequently, tend to form a stronger coke", and that this was "confirmed by the evidence of tests of coke strength conducted by plaintiff. (Ex. PP.)" In unrebutted testimony, Dr. Johnson, a consulting geologist, stated (II-R. 1001) that the greater plasticity and lower sulphur content of the Raton coal resulted in a "standoff" between that coal and Sunnyside coal. As noted, the District Court so found.

In short, even on taxpayer's own theory—that the representative market prices are the prices paid by Colorado Fuel with "adjustments" for differences between Koehler and Sunnyside coal—the dollar figures

claimed by taxpayer are unsupported. The differences between the two coals for coking purposes offset each other in a "standoff" in the open market in which they competed directly with each other. Thus taxpayer is left with a differential of 30 per cent between the prices paid by Colorado Fuel and its claimed dollar figures, whereas there is only a minimal difference of 7 to 8 per cent between the Colorada Fuel prices and the representative market prices derived by the District Court from the sales of Sunnyside coal by Utah Fuel and taxpayer. Moreover, when sales of Koehler coal for non-coking as well as coking purposes are taken into account—as the District Court properly found they should be—the average market price of Koehler coal is even lower and, as the District Court further found, confirms the representative nature of the prices obtained by Utah Fuel and taxpayer.

It would be inappropriate to extend this brief with a detailed discussion of taxpayer's alternative contention (Br. 58-60) that its representative market prices are the prices paid for low-volatile Arkansas-Oklahomo blending coal—again with "adjustments". This coal is simply an additive in the coke-making process, a small portion being blended with a large quantity of high-volatile coking coal (such as the Koehler and Sunnyside coal) to arrive at a coke with optimum strength at most economical cost. It is high-volatile coking coal and its representative market prices which are at issue, and there is considerable sales data in the findings and the record with respect to such coal. It would obviously be inappropriate, in any event, to construct a hypothetical representative

market price for high-volatile coking coal from prices paid for the low-volatile additive which, as the District Court found (I-R. 47) is not a mineral product of "like kind and grade".

For all of the foregoing reasons, we submit that the District Court was amply warranted by the record in deriving the representative market price for Sunnyside coal from the sales of such coal on the open market by Utah Fuel and taxpayer, and in finding that competitive sales in the same market of Koehler coal confirmed the representative nature of Sunnyside prices.

D. *The record amply warrants the District Court's finding that the sales prices obtained by Utah Construction and Mining Company for its iron ore established the representative market prices for taxpayer's iron ore*

1. *Sales by Utah Construction and Mining Company*

In manufacturing its iron and steel products, taxpayer used iron ore which it mined from its Vulcan Mine and Eagle Mountain Mine, both in California, together with iron ore purchased from other miners. (I-R. 33-34.) Utah Construction and Mining Company (hereinafter Utah Construction) was an independent company mining and selling iron ore from its mine at Iron Springs, Utah. From 1946 to 1954, Utah Construction sold substantial tonnages of iron ore to taxpayer. The ore thus purchased constituted over 20 per cent of the iron ore consumed by taxpayer during the years in suit. Utah Construction also sold large tonnages of its ore to many other customers, including cement companies. (I-R. 35-37.)

The District Court found (I-R. 39-40) that Utah Construction's iron ore, whether used in a blast furnace, an open-hearth furnace, or in the manufacture of cement, was a mineral product of "like kind and grade" to the ore mined by taxpayer. The court further found (I-R. 40-41) that Utah Construction's sales during the years in suit to its various customers, including taxpayer, "were arm's-length transactions in which ore moved in commerce in an area which included [taxpayer's] mines and therefore established a representative market price for iron ore mined and shipped" by the taxpayer from its California mines.

Taxpayer paid Utah Construction an average price per net ton f.o.b. Iron Springs of $1.869 during its fiscal year ended June 30, 1949, and $1.901 during its fiscal year ended June 30, 1950. The weighted average f.o.b. mine prices paid by all Utah Construction's customers, including taxpayer, during its fiscal years ended October 31, 1948, 1949 and 1950, were $2.04, $2.39 and $1.88, respectively. (I-R. 36-37.) The District Court found (I-R. 41) that the representative market prices for taxpayer's iron ore during the taxable years were $2.29 and $2.03 per net ton, respectively. Taxpayer claims substantially higher dollar figures as the representative market prices of its iron ore. (I-R. 34-35.) In attempting to support these figures on appeal, taxpayer asserts that Utah Construction's prices were not representative market prices and invokes other sales data, discussed below.

Before discussing taxpayer's arguments as to Utah Construction's prices, it should be recalled that the governing regulation speaks only of a "representative

mist, appearing as taxpayer's own witness, testified (II-R. 639-640) that a market existed for Utah Construction's ore. This perhaps is supererogatory; the existence of the market is attested by the very substantial tonnages sold by taxpayer to a variety of customers.

As for the substantial sales for export to Japan, these sales did not reflect a "temporary business opportunity," but rather was a significant and continuing segment in the western iron ore market both during the years in issue and thereafter. After the Japanese iron ore market reopened in 1948 with the sales by Utah Construction, iron ore was exported from the United States to Japan in every year from 1948 through 1953 save for 1950 [12] with Utah Construction alone selling for export 48,000 tons in its fiscal year 1948, 309,000 tons in its fiscal year 1949 and 717,000 tons in its fiscal year 1951. (Exs. A, U.) And, the continuing and expanding character of the Japanese export market was later corroborated by taxpayer's own sales of substantial quantities of Eagle Mountain iron ore to the Japanese commencing in 1956. (Ex. 22, II-R. 756-757.) Moreover, whatever limitations taxpayer claims were put on the price that Utah Construction could charge for the iron ore which was to be exported are of no import for Utah Construction was not forced to make any of these sales if it felt it was receiving an inadequate price therefore.

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[12] United States Department of the Interior—*Materials Survey, Iron Ore*, May, 1956.

Taxpayer summarily dismisses sales of iron ore by Utah Construction to cement companies for use in making cement and to foundries for use in open-hearth furnaces as being sales "of a different commodity or for a special purpose." (Br. 31.) As noted above, iron ore sold by Utah Construction, whether for use in a blast furnace, an open-hearth furnace or by a cement company, had the same physical and chemical characteristics, varying only in the size of the lumps. It is therefore not a different commodity. Nor, as was fully discussed in that section of this brief devoted to coal, does a sale for a different end use exclude such sale from being used to determine a representative market price for the same mineral.

Finally, taxpayer urges that the District Court erred in using Utah Construction's mine price because (Br. 41) "the 'mine' price which is to be used for the purpose of depletion can only be derived at by deducting from the representative market price paid by the buyer the segment of that price which consists of the cost of delivering that ore from the mine to the buyer." That is, taxpayer urges that a representative market price be found and that a "mine" price be derived therefrom. (See Br. 42-44.) In addition, taxpayer urges that the District Court erred even in selecting the mine price to be used. The use by the District Court of the Utah Construction mine price is supported by Treasury Regulations 111, Sec. 29.23 (m)-1 which states:

> If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the *representative market or field price* (as of the date of sale) *of a mineral product of like kind and grade* as beneficiated by the ordinary treatment processes actually applied, *before transportation* of such product.

Thus, the applicable Regulations make no distinction between representative market or field price and mine price, but rather equates the two since the representative market or field price is to be determined *before* the mineral is transported away from the mine, i.e., is to be determined by the price paid for the mineral of like kind and grade where mined.

2. *Lower Lake port prices for Mesabi Range iron ore cannot be used to establish a representative market price for taxpayer's iron ore*

Taxpayer urges that lower Great Lakes port prices be used as the measure for its own iron ore. A recent decision is pertinent here.

In *Ames* v. *United States*, decided November 13, 1962 (10 A.F.T.R. 2d 5963) (Ariz.), affirmed, 330 F. 2d 770 (C.A. 9th), the taxpayer produced crushed limestone from its quarry in Arizona. It did not sell this limestone but used it in its adjacent plant to make calcined lime which it then sold. The sole issue in the case involved the determination of the rep-

resentative market price for the taxpayer's limestone. At the trial, evidence was received showing sales of limestone in Arizona, in the Sacramento-Placerville area of California, and in Michigan. The District Court found a representative market price for the taxpayer's limestone on the basis of the Arizona sales. It also held that the California and Michigan sales were of no weight because of the remoteness of the sites of such sales from the area of the taxpayer's operations, and the differences as to size and quality of the materials involved and the absence of evidence regarding comparative shipping costs.

The court in *Ames* thus recognized the obvious fact that in order for sales to have significance they must bear some relation to the circumstances of the particular taxpayer involved. Thus, the California and Michigan sales were found to have no bearing on the search for a representative market or field price for limestone mined by the taxpayer in Arizona in the absence of evidence relating these sales to the taxpayer's mineral.

Similarly, in the instant case, the record evidence shows and the District Court found (I-R. 40) that taxpayer had neither bought nor sold iron ore in the Lower Lake port market or at Lower Lake port prices and that no iron ore extracted in the Great Lakes region of the United States was sold or shipped to the Western United States from the Lower Lake ports. And, taxpayer's own witness, Mr. Pardee, admitted (II-R. 612) and the District Court found (I-R. 40) that the Lower Lake port pricing structure for iron

ore did not constitute a "national representative market" for iron ore.[13]

Whatever else may then be said about Lower Lake port prices, it is evident that they have no relationship to taxpayer's iron ore and are simply not in any way representative of a market price for taxpayer's ore. From the record evidence, the only iron ore prices that do bear significant relationship to taxpayer's ore are the Utah iron ore prices which include sales of such ore to taxpayer. The extent of taxpayer's own purchases of this Utah ore indicates that it was satisfactory for use in taxpayer's blast furnace along with its own iron ore and that it was economically feasible to ship the ore from Utah to California. To disregard the Utah ore prices and to turn to Lower Lake port prices for Mesabi Range ore as being representative of taxpayer's iron ore makes no sense and would involve construing the phrase "representative market or field" in a manner so broad as to render the term meaningless.

In order for market prices to be representative of the taxpayer's mineral, they must be typical of the price which taxpayer's mineral would command if it

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[13] That the Lower Lake port pricing structure does not establish a national pricing system for iron is not surprising because approximately 75 to 80 percent of the iron ore shipped to the Lower Lake ports is captive ore (the same as the ore mined by taxpayer for its own use) and the actual prices at which iron ore is sold at the Lower Lake ports are generally lower than the published prices owing to discounts from the base prices contained in many of the sales contracts. (II-R. 606-607.)

were offered for sale. Prices, on the other hand, cannot be representative if they are established in a totally unrelated market in which the taxpayer did not and could not participate even if it desired to do so. But, that is precisely the situation with respect to taxpayer's ore and the proposed use of Lower Lake port prices to establish a representative market price therefore. They are simply unrelated. By way of contrast, the Utah iron ore prices bear an actual proven relationship to taxpayer's iron ore which taxpayer cannot explain away and which relationship is absent in the case of the Lower Lake port prices. As found by the District Court (I-R. 40):

> The sales of iron ore in the Great Lakes region, either at the mine or at the lower Great Lakes ports, are of no weight in this case because of the remoteness of the sites of such sales from the area of plaintiff's operations and the absence of any sales or shipments of such ore to the area of plaintiff's operations. The Great Lakes area was an independent market insofar as the plaintiff is concerned and sales within that independent market area had no economic effect upon plaintiff's market area and did not establish or effect the representative market area and did not establish or effect the representative market price for either Eagle Mountain or Vulcan iron ore.

Continuing, the court stated with regard to the sales of Utah iron ore, that (I-R. 40-41):

> The sales of iron ore by Utah Construction and Mining Company during the years in suit to its various customers, including plaintiff, were

> arm's-length transactions in which ore moved in commerce in an area which included plaintiff's mines and therefore established a representative market price for iron ore mined and shipped by plaintiff from its Vulcan and Eagle Mountain Mines during the years in suit.

We submit therefore that the Utah iron ore prices are relevant, that they are representative and that they, not Lower Lake prices, should be used in determining taxpayer's gross income from mining its ore.

In addition to our basic disagreement with the use of Lower Lake port prices to establish a representative market price for taxpayer's iron ore, issue must also be taken with the manner in which taxpayer attempts to construct such price. The fallacy in taxpayer's use of Lower Lake port prices lies in the fact that such prices include assorted charges such as rail freight from the mine to Upper Lake ports, lake freight to Lower Lake ports, dock unloading charges, federal transportation taxes, interest, insurance, and other incidental charges. (Ex. SS, p. 240.) Depletion, however, is an allowance for the exhaustion of a capital asset (*United States* v. *Cannelton Sewer Pipe Co., supra*) and under the Code, the measure of this capital asset is "gross income from mining". Therefore, only those costs which are incurred in connection with the taxpayer's mining operation are properly includible in any determination of income from mining. As the Lower Lake port prices include the charges enumerated above—all of which are incurred after the mining operation is completed—use of Lower Lake port prices in connection with computing gross

income from mining under any method is manifestly improper and contrary to the applicable depletion statute and Regulations. Taxpayer apparently recognizes the difficulty in its failure to use mine price for it states (Br. 36) that "since we are concerned with a mine price, for it is also necessary to reduce this adjusted price by the freight from the Eagle Mountain and Vulcan mines to Fontana." Although the deduction of that freight charge reduces the price used, it nevertheless fails to remedy the basic error in the use of the Lower Lake port prices due to the inclusion in that price of charges incurred subsequent to the mining operation.

Nor does taxpayer's effort to derive a price for its iron ore based on an assumed relationship between the price of iron ore and the finished steel prices of the Eastern producers support the use of Lower Lake port prices. For our purposes, however, the testimony on this point by taxpayer's witness, Mr. Carrier, is interesting for several reasons. Mr. Carrier stated that, as an initial step, careful attention was given to the actual sales of iron ore in the West in the years 1949 and 1950 because sales prices in a free and competitive market in the general area in which the captive ore was located would tend to be the best evidence available of a representative market price. (II-R. 633.) He discarded the actual sales of Utah iron ore, however, because in his view, the market for Western iron ore was "very thin". (II-R. 639-640.) Thus, at the outset, the market for Western iron ore,

though conceded to have existed during the years in issue, was discarded in favor of some other market.[14] Implicit in this action was an assumption that "representative market or field price" within the meaning of the Treasury Regulations, required some particular or pre-conceived type of market.[15] As was discussed earlier in this brief, the assumption is erroneous. Under the applicable Regulations, in order for the comparative market method to be applicable, the requirement is that there be a market[16]—not a "fat" one or a "thin" one, but simply a market. In Mr. Carrier's view, there was a market for Western iron ore during the years in issue, albeit a "thin" one, and that market included the sales of iron ore by Utah Construction to taxpayer and several other purchasers. Without anything more, we submit that on

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[14] The method he eventually used in calculating an "imputed" price for taxpayer's ore involved the development of a mathamatical formula and working back from statistics on pig iron prices to his hypothetical iron ore price.

[15] Thus, Mr. Carrier stated that a representative market price had to stem from a free and competitive market but that "outside of the world of abstract economics and textbooks there is no such thing as a perfectly free and competitive market". (II-R. 641.) Apparently in Mr. Carrier's view it would only be the extremely rare and unusual market that would produce representative market prices for purposes of computing income from mining for depletion purposes under the applicable Treasury Regulations. As noted earlier, there is no basis under the Regulations or in the decided cases for such a restricted interpretation.

[16] Given such a market, prices established therein, in Mr. Carrier's words, "would tend to be the best evidence available of a representative market price". (II-R 633.)

Mr. Carrier's testimony alone, we have the market which reflects the representative market or field price for taxpayer's ore and which resolves this issue.

Finally, it must be noted that taxpayer in its attempt to support its claim for a higher depletion allowance was not satisfied to use Lower Lake prices by themselves but insisted upon making upward adjustments to the port price to compensate for the greater iron content of its ore over that of the Mesabi non-Bessemer ore. As was discussed earlier in great detail, such adjustments do not result in a representative market price being reached, but rather are concerned only with the relative values of minerals—a determination which is not here in issue. Moreover, taxpayer in making adjustments to a base price again, as it did with regard to the adjustments made on the coal prices, he failed to make downward adjustments for an adverse quality of its mineral. In the case of iron ore, taxpayer has failed to adjust downward its derived value for the greater sulphur content (a deleterious element) of its iron ore over that contained in the Mesabi non-Bessemer ore.

In summary, the record evidence establishes the existence of a continuing market with respect to Utah iron ore in which taxpayer was an active participant. Moreover, taxpayer itself recognized the existence of this market when it originally prepared its tax returns for the years in issue. The Utah iron ore prices are now unsatisfactory to taxpayer because they are not high enough to support its claim for greater depletion allowance. But, its claim that these sales can be "explained away" simply does not stand up under

the heavy weight of the evidence to the contrary. Accordingly, taxpayer's depletion allowance for its iron ore was properly determined by the District Court on the basis of the Utah iron ore prices.

CONCLUSION

For the reasons stated above, the decision of the District Court should be affirmed.

Respectfully submitted,

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APRIL, 1968.

Certificate

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: .... day of ...., 1968.

____
Attorney

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 114 [as amended by Sec. 145(a), Revenue Act of 1942, c. 619, 56 Stat. 798; Sec. 124(a) and (c), Revenue Act of 1943, c. 63, 58 Stat. 21; and Sec. 15(b), Act of August 8, 1947, c. 515, 61 Stat. 917]. BASIS FOR DEPRECIATION AND DEPLETION.

* * * *

(b) *Basis for Depletion.*—

* * * *

(4) *Percentage depletion for coal, bauxite, fluorspar, flake graphite, vermiculite, beryl, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, ball, sagger, and china clay, rock asphalt, phosphate rock, trona, bentonite, gilsonite, thenardite, and metal mines, potash, and sulfur.*—

(A) *In General.*—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, bauxite, fluorspare, flake graphite, vermiculite, beryl, feldspar, mica, talc (including

pyrophyllite), lepidolite, spodumene, barite, ball, sagger, and china clay, phosphate rock, rock asphalt mines, trona, bentonite, gilsonite, thenardite (from brines or mixtures of brine), and potash mines or deposits, 15 per centum, and in the case of sulfur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(B) *Definition of Gross Income From Property.*—As usual in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining", as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—

cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulphur—pumping to vats, cooling, breaking, and loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; and (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purpose of sections 731 and 735.

(26 U.S.C. 1952 ed., Sec. 114.)

Treasury Regulations 111:

Sec. 29.23(m)-1 [as amended by T.D. 5413, 1944 Cum. Bull. 124; T.D. 5458, 1945 Cum.

Bull. 45; and T.D. 5461, 1945 Cum. Bull. 284]. *Depletion of mines, oil and gas wells, other natural deposits, and timbers; depreciation of improvements.*—

* * * *

(f) The term "gross income from the property", as used in sections 114(b)(3) and 114(b)(4)(A) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the following:

* * * *

In the case of a crude mineral product other than oil and gas, "gross income from the property", as used in section 114(b)(4)(A) means the gross income from mining. The term "mining" as used herein includes not only the extraction of ores or minerals from the ground but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products.

If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product. If there is no such representative market or field price (as of the date of sale), then there shall be

used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

The term "ordinary treatment processes", as used herein, shall include the following:

(1) in the case of coal—cleaning, breaking, sizing and loading for shipment;

* * * *

(3) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment.

* * * *

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No. 22272

In the

United States Court of Appeals

For the Ninth Circuit

KAISER STEEL CORPORATION, *Appellant,*	
vs.	
UNITED STATES OF AMERICA, *Appellee.*	

Appeal from the Judgment of the United States District Court for the Northern District of California.

Appellant's Reply Brief

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SUBJECT INDEX

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I. INTRODUCTION

The difficulty in preparing a reply brief in this case does not lie in answering the points which are raised in the Government's brief. Rather it is in synthesizing the relevant issues in the case to which a reply properly should be directed and in refocusing the Court's attention upon the clear legal errors in the decision of the lower Court.

II. NATURE OF THE SIGNIFICANT ERRORS OF THE DISTRICT COURT

The Government seeks refuge in the claim that the significant questions involved are solely ones of "fact" and that the District Court has carefully weighed "voluminous evidence" which adequately supports its findings of fact. Since the findings of "fact"

are not clearly erroneous, says the Government, there is nothing really for this Court to do.

The case does involve a voluminous amount of evidence. With scarcely any exceptions, however, this consists of agreed upon facts or of facts which are not in any way controverted in the record. The real issues lie, then, in the fact that the District Court, having before it a set of largely undisputed facts, either misapplied or failed to apply proper legal standards.

To the extent that the District Court drew from the undisputed underlying facts inferences which are, in truth, inferences of fact, it is amply demonstrated that such factual conclusions are clearly erroneous under the classical standard for appellate review. However, by and large, resort to this test is not necessary.

The central issue in this case is the determination of the representative field or market price of the mineral products mined by Kaiser. This determination involves the application of legal standards. In *U. S. v. Henderson Clay Products,* 324 F.2d 7 (5th Cir. 1963) the taxpayer was an integrated clay miner-brick manufacturer who sold none of its clay at any stage prior to the finished brick product. To establish the taxpayer's gross income from its clay mining operations, the District Court determined the representative market price of taxpayer's clay by reference to sales of similar clay in other parts of the United States by non-integrated miners. The Court found the average price of these sales to be $10.50 per ton and calculated taxpayer's depletion allowance accordingly. 199 F. Supp. 304. The Fifth Circuit Court of Appeals reversed, but not because it found anything wrong with the lower Court's factual findings as to the price at which non-integrated miners were selling their clay during the tax years in question. Rather, the Court of Appeals found that the sales relied upon by the District Court were not "representative" of the value of the taxpayer's clay. 324 F.2d at 15. The Court of Appeals noted that "representative market or field price is not a boiler plate . . ." and stated:

> "The Regulation does not allow the indiscriminate use of any price of a product of like kind and grade, but requires the price to be representative; 'representative' should be

> interpreted to qualify the entire phrase 'market or field price'." (324 F.2d at 14).

Thus the Fifth Circuit dealt with the ultimate finding of a representative market price as a classic question of law—the application of the legal standard "representative" to the basic evidentiary facts determined by the District Court.

In *Kippen v. American Automatic Typewriter Co.,* 324 F.2d 742 (9th Cir. 1963), the question to be decided was whether the defendant had "good cause" to terminate one of its distributor's contracts. The District Court found on the basis of the facts that "good cause" existed. The Court of Appeals reversed, noting specifically that it was not bound by the "clearly erroneous" rule as to the finding of good cause. The Court observed (324 F.2d at 745): "The conclusion that American therefore had 'good cause' to discharge Kippen was a conclusion of law, since it was based at least in part upon the application of a legal standard." Further, the Court noted:

> "In Lundgren v. Freeman, 9 Cir., 307 F.2d 104, 115, we defined a conclusion of law as one 'based on application of legal standard'. Similarly, in Galena Oaks Corp. v. Scofield, 5 Cir., 218 F.2d 217, 219, it was stated that insofar 'as the so-called ultimate fact is simply the result reached by the processes of legal reasoning from, or the interpretation of the legal significance of, the evidentiary facts, it is subject to review free of the restraining impact of the so-called clearly erroneous rule."

The foregoing is particularly applicable where, as here, the findings deal with the effect of a series of transactions or events. In such circumstances the Appellate Court is free to draw its own conclusions. *Stevenot v. Norberg,* 210 F.2d 615, 619 (9th Cir. 1954).

Here the decision of the District Court rests upon the misapplication of the legal standard of "representative" market price in many instances and a complete failure by the District Court in other instances to apply the proper legal standards which that Court itself concluded were applicable.

A. Use of Any Price as a "Representative" Price.

One of the more obvious errors has to do with the District Court's interpretation of a "representative" market or field price. The ultimate issue is to determine Kaiser's "gross income from the property" for depletion purposes. If the product involved is sold, then, of course, the gross income from the property is the amount for which such product was sold. But if the product is transported or processed (Kaiser's products were both) and used by an intergrated producer, then in order to establish "gross income from the property" it is necessary, according to the regulations*, to use the *representative* market or field price of a mineral product of like kind and grade. The Government urges here (brief p. 29) the same view which was adopted by the District Court, namely, the position that *any* transaction by others establishes a market price because that particular transaction is "representative" of the market in which the transaction occurred. To adopt such a position is to render meaningless the term "representative". The legal standard that the transaction must be "representative" is fixed by law and the regulations. To repeat the language in *U. S. v. Henderson Clay Products, supra,* 324 F.2d at 14:

> "The Regulation does not allow the indiscriminate use of any price of a product of like kind and grade, but requires the price to be representative; 'representative' should be interpreted to qualify the entire phase 'market or field price'."

The cases have held, without exception, that the legal standard requiring the price to be "representative" must be applied in looking at the facts of any particular transaction to determine whether or not it is such a transaction as can reliably be included in establishing a "representative" market price. If not, the transaction must be rejected. For example, in *U. S. v. Cannelton Sewer Pipe Co.,* 364 U.S. 76, 78 it was found that certain sales of ground and bagged fire clay and shale were too negligible to furnish an "appropriate basis". In *Alabama By-Products Corp. v.*

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*Section 29.23(m)-1, Regulations 111, Appendix C, Kaiser brief.

Patterson, 258 F.2d 892, 899 (5th Cir. 1958) certain sales resulting from "peculiar economic conditions" were rejected as a basis establishing a "representative" market price. In *North Carolina Granite Corp.,* 43 T.C. 149 (1964) the taxpayer produced a certain high grade granite which commanded a price of around $9 a ton when sold for use as poultry grit. The same material also could be sold for roadbuilding material at around $1 per ton. The Commissioner argued that the latter figure was the proper one to use for depletion purposes, but this argument was rejected. The Tax Court said the prices of the material for roadbuilding purposes "were not representative of the value of the product to the poultry industry." (43 T.C. at 161).

Numerous other cases cited on pages 20 to 23 of Kaiser's brief clearly uphold the rule that not *every* price at which a particular transaction occurs is a "representative" price. The Government cites no authority to the contrary and, indeed, in its brief does not comment at all upon these important authorities.

The case of *Woodville Lime Products Company v. U.S.,* 263 F.Supp. 311 (N.D. Ohio 1966) is another clear example of the rule that not every price is a "representative price" and that the legal standard of "representativeness" must be met. In this case the Court stated at page 321:

> "Ordinarily one might presume that actual sales would furnish a proper basis for determining a constructive price for unsold materials. However, as this case makes clear, the *nature of the market in which those sales occurred* must be explored before any *conclusion* can be drawn regarding the 'representativeness' of actual sales." (Emphasis added)

Even the Government recognizes the fundamental correctness of this position for, in an unguarded moment, the Government observes "distress sales at sacrifice prices are unlikely to be representative or typical market prices" (Government brief, p. 34). The Commissioner, in his 1966 proposed regulations*, provides

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*Appendix E, Kaiser Brief, p. 20. The proposed regulations are "strongly persuasive of the Commissioner's view of the proper construction of the statute." *Henderson Clay Products v. U.S.,* 377 F.2d 349, 354 (5th Cir. 1967).

for the use in determining representative market only of sales which "are the result of competitive transactions." For the purpose of determining representative market or field price "exceptional, nominal, unusual, tie-in, or accommodation sales shall be disregarded."

A clear example appears with respect to the sale of iron ore. The uncontradicted testimony in this case is that fine ore is not suitable for use in the blast furnace. The Court found that "Physical . . . differences have importance if they are recognized in commercial competition" (Conclusion 6, R. 52). Utah Construction Company built up a large stockpile of fine ore as the residue of other shipments over a considerable period of time. In 1950 a large volume of this undesirable ore was unloaded on Geneva Steel Company in a special transaction at a very low price. This transaction, at a price which was quite obviously dictated by the distress nature of the merchandise, is nonetheless included in the representative transactions used to establish the price for Kaiser's iron ore*. The inclusion of this sale results from the application of an erroneous legal standard by the District Court as to what transactions are "representative" transactions†.

The Government (brief p. 30) cites *Riverton Lime & Stone Co.*, 28 T.C. 446 (1957) for the proposition that even a small declining market can establish a representative price, but in that case the Court did not close its eyes to surrounding circumstances. Indeed, there the Government was arguing that depletion should have been determined from computed prices derived on the basis of selling the taxpayer's limestone in its quarried state for agricultural purposes. The Court rejected this contention on the strength of its finding that the taxpayer did not sell for this purpose because of an abundance of other limestone in the area which was more suited

*District Court Finding No. 22, R. 37.

†The complete inconsistency followed in applying this standard is illustrated by the Court's Finding No. 63 (R. 47) to the effect that prices for different coals cannot be used unless they are a "complete substitute" one for the other, since they are not of like kind and grade. Using this criteria it is obvious that these "fines" cannot be representative of Kaiser's ore.

to agricultural use. In fact, the Court in *Riverton* even examined the question of suitability for a particular use in determining the representative nature of sales or potential sales in a particular market.

On the other hand, in the instant case the District Court was persuaded by the Government's argument that any transaction is a "representative transaction" because the price at which that transaction took place is "representative" of the transaction which occurred. It was in failing to give consideration to the facts surrounding the particular transaction (which facts were largely undisputed in this record), for the purpose of applying the legal standards as to what is a "representative" price that the Court is in error.

Not only did the Court err in establishing a market price for depletion purposes by *including* transactions which do not meet the test of being "representative" — it compounded this error by excluding the only transactions which were truly "representative." The most startling example is the exclusion of the Raton coking coal prices. The Court found as an evidentiary fact that "The Raton-Mesa coal and the Sunnyside coal of the plaintiff competed directly in the market place, were both suitable for production of coke when blended with low volatile coal and were similarly utilized . . ." (Finding 70, R. 50). When it came to establishing a representative market price the Court, however, completely failed to include any of the sales of Raton-Mesa coal. This is clearly apparent from Exhibit XX, which is the basis of the Court's Finding 52 (R. 45) in which it determines the representative market price for coking coal.

B. Failure to Make Price Adjustments Recognized in the Market.

Another erroneous application of legal standards by the District Court and supported by the Government here is the proposition that once a transaction "price" has been determined, there can be no adjustments for "value"; and the Government belabors at length the point that market price and market value are different concepts. Again, however, the Government sidesteps the funda-

mental issue. For if it is shown, as it was demonstrated by the uncontroverted evidence in this case, that products with differing qualities command differing prices in the market place because of those qualities, then a comparison of those products for the purpose of establishing a "representative" market price must take into account the pricing differences *which the market itself would consider*. To call differences in price which the market place would attach, were a product to be sold in the market, a "value" adjustment is a mere exercise in semantics.

A clear example of such error occurred with respect to the comparison of the Sunnyside and the Raton coal. The Sunnyside coal was a washed coal and it also had a lower ash content than the Raton coal. The evidence established beyond doubt that if the two coals were to be sold in the market place, commercial competition would cause the market price to be higher for the Sunnyside coal to reflect the fact of the washing and also the fact that the Sunnyside coal had a lower ash content. However, in comparing these two coals, the District Court chose to ignore these pricing factors, despite the overwhelming evidence that they were recognized in the market place.

In the regulations which he proposed in 1956* (later withdrawn and modified) the Commissioner was not oblivious of the price adjustments made by businessmen in the market place for he provided that in making price comparisons there should be "proper adjustments" for "material differences, if any, between the taxpayer's gross income product and the products sold commercially."

The greatest anomaly of the situation lies in the fact that the Court recognized the standard in its Conclusion of Law No. 6. "Minerals are like kind and grade if they are substantially equivalent by commercial standards. Physical, chemical or geological differences have importance only if they are recognized in commercial competition." (R. 52). It simply failed to follow the standard.

It should be borne in mind that the market "price" for Kaiser's coal and iron ore can never be determined with absolute certainty.

*Appendix D, Kaiser brief, pp. 9-10.

The reason is that Kaiser did not sell its iron ore or coal, but rather used these minerals in the production of iron and steel. Therefore, the best that can ever be done is to attempt to arrive at the price at which these products would have been sold, had they been sold by an independent operator of the Sunnyside coal mine and the Eagle Mountain ore mine. This price must by definition be a hypothetical price and not an actual price. In this hypothetical transaction (which did not in fact occur) it cannot be assumed that the hypothetical seller was willing to sell the product for anything less than it was "worth" in the sense of what it would command in the market, or that the hypothetical buyer would pay anything more than the product was "worth". Therefore, whether the result we are attempting to determine is called a hypothetical sale "price" or a hypothetical "value" is a distinction without a difference.*

Although the District Court seemed to realize that what we are trying to do is to "estimate that part of the integrated producer's gross income that is attributable to mining" (Conclusion of Law No. 9, R. 54) it makes the remarkable statement that "opinions and estimates of what buyers could have paid or should have paid for that mineral are entirely irrelevant." (Conclusion of Law No. 7, R. 52). The fact is, that so far as the integrated miner-manufacturer who uses his own product is concerned, no actual sales transaction ever occurs. All the trier of fact can ever do in such cases is to apply the legal standard of "representative" market price and make its opinion and estimate of the price which the integrated operator could have paid or should have paid for the mineral in question. Far from being "irrelevant", this is the

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*The Government (brief p. 29) relies on *Shamrock Oil & Gas Corp. v. Coffee,* 140 F.2d 409 (5th Cir. 1944) which involved the determination of a "market price" for sour gas at the well. The court held that if there were sales which were "comparable and under terms and conditions similar to the terms and conditions involved in the contract under consideration" such sales should be used. (140 F.2d at 411) However, the court further noted that *in the absence* of comparable sales under similar terms and conditions, value "could be shown by opinion evidence in an effort to fix market price" and, in such a situation, the terms market price and market value are "interchangeable."

central issue to be determined. In making such determination the trier of fact not only can, but must, consider whether other transactions to be examined are, on their facts, truly representative and whether the prices at which such other transactions occurred would, as in the instant circumstances, require adjustment because of pricing factors recognized in the market place.

C. Failure to Adjust for Freight.

A further and very obvious failure to apply correct legal standards was made by the District Court with respect to the treatment of freight on iron ore. Under the applicable regulations depletion is computed upon the basis of the gross income from the property. The property referred to is the taxpayer's mine and not the mine of some other mineral producer. The taxpayer "is deemed to sell to himself the crude mineral product *he* mines." (Conclusion of Law No. 9, R. 53). He mines the product from *his mine.* The test is clearly enunciated in the *Cannelton* case (page 27 of the Government's brief) wherein it is observed that the cutoff point is "where the ordinary miner shipped the product of *his* mine" (Emphasis added). Reverting again to the Commissioner's 1956 proposed Regulations* we find that the price to be determined is the price "at which the gross income product is sold commercially *in the vicinity of the taxpayer's mine.*" (Emphasis added). Absent such sales, we must determine the price at which the "gross income product would be sold if such commercial sales existed" (i.e., sales made at the locus of the taxpayer's mine).

The Court rejected the taxpayer's contention that prices established in the only recognized United States ore market at the Lower Lake ports should be used. Instead, the Court used prices of ore sales by Utah Construction Company. It is undisputed that there were no significant sales at the taxpayer's mine or from any mine in the vicinity thereof (and the Utah Construction Company mine in Carbon County, Utah, is certainly not in the vicinity of San Bernardino County, California). Assuming, *arguendo,* that

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*Appendix D, Kaiser brief, p. 9.

the Court's determination was correct, then a representative market price must be determined at some point where a representative market in which the taxpayer could sell is found to exist, and the price at the taxpayer's mine can only be determined by subtracting from that market price the freight from the taxpayer's mine to that market. In the instant case this means using the export ore prices at Long Beach and subtracting from this price the freight from Kaiser's mine to Long Beach. A failure to make such a determination, as the District Court fails to do in this case, is clear error. The Government's own witness, Dr. Jones, testified that that was the way to do it (Tr. 859, lines 9-13).

We submit, therefore, that the question is not whether the determination by the District Court of the underlying facts is clearly erroneous, but rather, on the basis of those facts, whether the District Court failed to properly apply legal standards. We say it did not. With this in mind, we turn to a more detailed examination of positions advanced by the Government's brief.

III. IRON ORE

A. Representative Market Price.

Kaiser has reviewed in detail in its opening brief (pp. 7-10, 28-33) the circumstances surrounding the sales of iron ore by Utah Construction Company and has set forth the compelling reasons why such transactions do not meet the test of a "representative" market price. The impropriety of using the sale of 422,913 net tons of undesirable fine ore to Geneva Steel Company in the fiscal year ending October 31, 1950, already has been discussed. (supra p. 6) This sale accounted for more than 50% of the total sales of Utah Construction Company for that fiscal period. Apart from this distress sale, the export sales and the sales to Kaiser itself, the dealings of Utah Construction Company in iron ore during the periods in question were insignificant in amount. This is readily apparent by reviewing District Court Finding No. 22 (R. 36-37). All of the sales, except to Kaiser and in export, were in an unrelated geographical market. None of the sales were the result of competitive transactions.

The specific evidence and circumstances concerning the Japanese export sales have been discussed in detail in Kaiser's opening brief (pp. 39-44). The Government brief improperly supplements the record in this regard by citing material (on p. 56) concerning later sales in export from sources which were not in evidence in the case. Nevertheless, the points made by the Government emphasize and reinforce the position of taxpayer that, if any sales by Utah Construction Company are to be used, it is only these export sales which meet the test of being "representative."

On page 56 of its brief the Government refers to "substantial tonnages" of iron ore sold by Kaiser to a "variety of customers." What transactions these were cannot be gleaned from the record. The only sales of iron ore by Kaiser Steel during the period in question were a sale of some 18,000 tons to Riverside Cement Company in the fiscal year ending June 30, 1949, and a sale of some 60 tons in the fiscal year ending June 30, 1950. (Exhibit 24). No finding was made by the Court in this regard since these sales were not regarded as being "representative." Incidentally, it may be noted that the mine prices for these sales were very significantly in excess of the prices found by the District Court to be representative prices for Kaiser's ore (Finding No. 35, R. 41).

The attack on the use of Lower Lake Port prices commences with citation of *Ames v. U. S.*, 330 F.2d 770 (9th Cir. 1964). That case had to do with the determination of a representative market price for limestone at the taxpayer's mine in Arizona. The lower court used for this purpose the price realized in arms length transactions by a nearby Arizona limestone plant and rejected market prices from the Sacramento-Placerville region of California and from areas in Michigan. This approach was upheld on appeal. Two important distinctions are at once apparent—first, there were sales of the mineral involved from nearby mines at reliable market prices. This factor is absent in our case. Secondly, in the *Ames* case there was no showing of any economic relationship between the California and Michigan sales on the one hand and transactions in Arizona on the other. Indeed, in *Ames* there were even differ-

ences in "size and quality" of materials as between the various locations. (330 F.2d at 772, fn. 4). The record in this case was entirely different. (Appellant's Brief pp. 33-39) It was demonstrated that the end product, namely iron and steel produced from Lower Lake ore, did have a significant economic relationship with products produced from Kaiser's ore. Such products moved from one part of the country to the other, and the prices of each affected the prices of the other. Though it is true that no Great Lakes ore as such moved into California, a very considerable and significant volume of products manufactured from Great Lakes ore did move into and affect California iron and steel markets*. On the basis of this evidence, which is undisputed, it was then clearly established that because of the relationship between the finished products, there is, in the economic sense, a price relationship between the raw materials. It is on the basis of this evidence that Kaiser proved that the Lower Lake Port ore price is an appropriate indication of the representative market or field price for Kaiser's ore.

The relevance of market prices from other areas has not been ignored even by the Commissioner. In Regulations proposed in 1956⁑ the Commissioner notes that if there are no commercial sales of the gross income product in the vicinity of the taxpayer's mine, then the market price of the gross income product must be determined by the use of "other appropriate methods" and that among the methods "that may be appropriate" is "comparison with prices at which crude mineral products or processed mineral products identical or similar to the taxpayer's gross income produce are sold commercially *in other areas*, with proper adjustments * * *."† (Emphasis added).

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*On the basis of the undisputed evidence of competition between products made with Lower Lake ore and products made with Kaiser ore, we submit that Finding No. 33 (R. 40) to the effect that Lower Lake ore "had no economic effect" on Kaiser's market area is clearly erroneous even by the classic test.

⁑Appendix D, Kaiser brief, pp. 9-10.

†Another example of the Court's inconsistency in applying the legal test of whether a particular transaction was representative, consists in the use by the Court of prices derived from sales of ore made by Utah

B. Freight Adjustment.

Turning now to the argument that the Lake Port prices are improper because they include freight from various mines to the Lake Ports (Government brief p. 62) it should be noted that the eastern iron and steel producers procure ore at the Lake Ports for use in their particular production facilities. Kaiser is merely saying that it procured ore at Fontana for use in its facility. Therefore, assuming that the delivered Lake Port prices and the delivered Fontana price are equated, as economic evidence indicates is proper, then it is in order to deduct, as Kaiser has done, the freight from Fontana to Kaiser's mine in order to determine the mine price at Kaiser's mine. This adjustment has been made. In order to determine the mine price at some other mine, assuming the Lake Port price to be a representative price at the point of sale, it is necessary to deduct from such price the freight between the point of sale and that particular mine. This fact, however, in no way weakens the relevancy of the Lake Port price.

Regardless of what market price is used, the freight adjustment (which the District Court failed to make) is necessary in all events. If, as *Cannelton* says, we are to determine the price at which Kaiser would have sold its ore had it not been an integrated producer, then we start from the premise that exporters purchased Utah ore delivered at Long Beach for \$7.65 per ton (Ex. 1). Assuming *arguendo* that the District Court is right in its conclusion that prices for Utah ore are representative of prices for Kaiser ore, we must assume that exporters would purchase Kaiser ore for the same \$7.65 per ton delivered at Long Beach.

Construction Company in unrelated markets remote from Kaiser's iron mine at Eagle Mountain, California. These include all of the sales by Utah Construction Company other than the sales made to the Kaiser Steel mill at Fontana and the export sales at Long Beach, California. The Court recognized the legal principle in Conclusion of Law No. 7 (R. 53) that "Prices paid by buyers in unrelated geographical markets . . . have no bearing" in determining a representative market price and therefore refused to apply the Lower Lake ore prices. It then proceeded to completely and inconsistently disregard this legal principle when it included sales of iron ore by Utah Construction Company which were made in geographical markets entirely unrelated to Kaiser's California iron ore mines.

What then is the Kaiser Eagle Mountain mine price for ore? It must be the price at Long Beach less the freight from that point to Kaiser's mine. So, if Kaiser was an independent producer selling to itself and others in its market area on the same basis that Utah Construction Company sold to Kaiser and the exporters, then the mine price on which Kaiser would compute its depletion would be the net mine price arrived at by deducting the freight from the delivered price. Determination of Kaiser's mine price on any other basis is clearly contrary to the teaching of the *Cannelton* case and clearly contrary to the statute and regulations. The Commissioner's proposed 1956 regulations (Appendix D, Kaiser Brief, pp. 9-10) required that "proper adjustments . . . for material differences . . . (such as differences in . . . transportation costs . . .)" be made.

C. Other Recognized Commercial Adjustments.

In order to be consistent with its stand on coal, the Government is forced to take the position (Brief, page 65) that adjustments in iron ore prices, for the purpose of determining a representative market price, to reflect greater iron content are "value" adjustments and should not be recognized. The testimony is undisputed (Exhibit SS, 1949-1950 Editions of Mining Directory of Minnesota—Table 15, page 235) that price is adjusted in the market on the basis of iron content and that this is uniformly done. The Government's position is not supported by a single fact in the record and is untenable as a matter of law.

The Government also raises the point that if adjustments are to be made in iron ore prices, then a downward adjustment should be made because of the greater sulphur content of the taxpayer's ore. The only difficulty with this contention is that there is no evidence in the record which directly or indirectly indicates that any *price* adjustment is made in the market for ore containing the sulphur content present in the Kaiser ore. On the contrary, the only testimony is that there would be no penalty (Pardee, Tr. 586-587). Further, the evidence is uncontradicted that the sintering process which is uniformly practiced in the West in order to improve the physical structure of ore (Christensen, Tr. 543;

Powell, Tr. 751) results in removal of any sulphur as an adjunct of the sintering.

IV. COKING COAL

A. Utah Fuel Company Transactions.

Turning to the question of coking coal, we start with the undisputed facts that the sales of coking coal by Utah Fuel Company were made in the commercial market and not for coking purposes, that the coal was not suitable for commercial purposes* and that it had been sold at a loss continually from 1929 through 1950 with the sole exception of a minimal profiit in the year 1949. (Kaiser brief, pp. 15, 45-49) The Government's brief acknowledges (p. 34) that "if a miner produces only one mineral from one mine and sells it below cost—a situation unlikely to continue for any length of time—the price will probably not be representative of prices charged by less irrational producers intent on a profit." That, in essence, is what Kaiser has been urging all along, namely, that sales of Sunnyside coking coal by Utah Fuel Company at less than cost for non-coking uses are not representative of prices which would be charged for coking coal in the usual market situation and do not meet the standard of a representative price for Kaiser's coking coal.

The Government's brief (p. 35 *et seq.*) proceeds to speculate at great length on the reasons why Utah Fuel Company continued to sell Sunnyside coking coal on the commercial market at a loss and wanders over a great range of possibilities. There is no need for such speculation; the record in this case clearly establishes why the Sunnyside coking coal was sold by Utah Fuel at a loss over this period of time. The reason is simply that Utah Fuel Company wanted to keep the Sunnyside mine open in the hope that it eventually could realize its potential by serving as a source of

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*The evidence reviewed on Page 46 of Kaiser's brief makes it plain that the District Court's Finding No. 41 (R. 42) to the effect that the Sunnyside coal was *"Suitable"* for non-coking uses is clearly erroneous. There is no evidence whatever in the record to support the lower court's conclusion and the Government brief mentions none.

supply of coking coal for a steel operation. (Heiner, Tr. 330-1). If that potential were realized, then the losses would be recouped and the coal could be sold to a steel maker at a realistic market price.*

As to the so-called "end use" test, (sales for commercial versus sales for coking purposes) the position of Kaiser is simply that while the question of use standing alone may be irrelevant, the purpose for which a product is sold is important in determining whether a particular price meets the standard of a representative market price. Thus where a product is adapted for a certain purpose and when sold or utilized for that purpose commands a certain price, that price is the representative price of the product. The fact that the product may unsatisfactorily be used for other purposes, and when so used commands a lesser price must be considered in deciding whether that price is a "representative" market price. The principle is well illustrated in *North Carolina Granite Corp.,* (supra).

It is further suggested (Government brief, p. 39) that if the Sunnyside coking coal of Utah Fuel Company could command a higher price when sold for coking purposes, it would have been

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*The Government in its brief refers (ft. 9, page 40) to the contract between Utah Fuel and Taxpayer (Exhibit 32). The reference is inaccurate. This contract is clear evidence that Utah Fuel was not intending to restrict itself to commercial prices. Utah Fuel was only agreeing to sell coal to Kaiser at commercial prices "for a period not to exceed one year" from date of the agreement in the sole event that Kaiser was unable to produce coal from the leased premises. It is obvious, as Mr. Heiner testified, that Utah Fuel's intention was to command the higher prices which the product would demand for coking use in the event the leased property could not be brought into production. This is fully evidenced by the later agreement entered into between Utah Fuel and Kaiser-Frazer (Exhibit 20 also referred to by the Government). Contrary to the Government's statement the price in this agreement was $4.50, *plus* additional adjustments for amortization and labor increases. More important, it gave Kaiser-Frazer the right to purchase Sunnyside coal not "at any more favorable price which Utah Fuel granted to any of its commercial customers" as claimed by the Government, but only at a more favorable price (a) secured for coal sold "for like or comparable use," (i.e., a coking use), or (b) for railroad locomotive use. It is apparent from the prices secured by Raton that coal for locomotive use sold at or about the same price as for coking use. (Finding No. 65, R. 48)

sold as such. To this suggestion the reply is: sold to whom? The record in the case clearly indicates that there were only three steel producers that utilized coking coal in the entire western United States, namely, Geneva Steel Company, which produced its coking coal from its own captive mines, Colorado Fuel and Iron Corporation, which obtained the great bulk of its coking coal from the Raton mine, and Kaiser, which procured its coking coal from the leased Sunnyside properties. These markets were satisfied and thus there was no opportunity for Utah Fuel Company to sell its excess coking coal production for coking purposes.

The fact that Utah Fuel Company may or may not have made a profit from other operations which it used to sustain its losing operation at Sunnyside is totally irrelevant. If the company chose to make sales at less than cost in order to work toward an ultimate business purpose and draw on the profits or resources from its other operations to sustain the Sunnyside mine, that does not bear on the question of the price Kaiser would charge for coking coal from its mine, nor does it serve to render the Sunnyside price a "representative" market price.

The suggestion that there were a great number of suppliers of coking coal (Government brief, p. 40) and therefore a buyer would be unlikely to pay a "premium" price for Sunnyside coal is not only untenable but highly misleading. Geneva Steel Company procured its supply from a captive mine and neither sold nor purchased any significant quantities of coking coal from outside sources except in extraordinary circumstances. Colorado Fuel and Iron Corporation purchased the bulk of its requirements from Raton Coal Company and obtained additional quantities from a number of small suppliers in the Colorado area. There is no showing whatever that these small suppliers could have produced any more than they did and indeed the testimony was that coal for coking purposes in that region was in very short supply. Nevertheless, it was the Raton mines which had *established* a market price for coking coal and this was where a buyer (Kaiser Steel) would have to go and the price he would have to pay. It is these prices which taxpayer contends must be used as the basis for

arriving at a representative market price for the Sunnyside coal. These are not *premium* prices—they are actual prices.

If the Sunnyside No. 2 Mine (which Kaiser leased) had been operated by an independent producer and not leased to Kaiser, then it would have been necessary for Kaiser to obtain coking coal from either Raton Coal Company or from that independent producer, or else close down its blast furnaces entirely. The Raton Coal Company price for coking coal is established by its sales to Colorado Fuel and Iron Corporation and it is undisputed that it would have been delivered at Fontana for the same freight rate as the coal from Sunnyside. (Kaiser's Brief, p. 52) This Raton price establishes what an independent producer at Sunnyside would have sold for. It is clearly evident that if Kaiser had been required to purchase on the open market from an independent producer the coking coal which it mined from the leased Sunnyside mine, such coking coal would have commanded prices at least as great as those paid by other users of the same product for coking purposes.

B. Kaiser's Coal Sales.

The number and size of sales of Sunnyside coal by Kaiser itself were so small, in relation to the size of its overall operation at the Sunnyside mine, as to be *de minimis.* (25,260 tons out of 416,615 for 1949 and 28,340 out of 591,568 for 1950—Findings 36 and 41, R. 41, 42-43). The transactions were not representative (Kaiser's Brief, pp. 14, 50-51). They were made at cost and came about when Kaiser was attempting to assist another steel producer whose mine had been shut down (Heers, Tr. 94-95), or as a result of losses of coal in transit by railroads (Heers, Tr. 97, 107, 117) and for other similar reasons unrelated to any market price for coal. Kaiser simply was not in the business of selling coal (Heers, Tr. 96) and the prices realized in these specialized transactions do not meet any of the standards of representative market prices.

The suggestions on pages 41 and 42 of the Government brief that Kaiser sold substantial tonnages of coking coal in 1951 and 1952 are completely misleading. Kaiser acquired the stock of

Utah Fuel Company in 1950 (Heers, Tr. 65) and dissolved that company into Kaiser Steel in 1951 (Heiner, Tr. 383). Utah Fuel Company had a number of mines other than Sunnyside. These mines produced only commercial coal *not* suitable for coking uses which was sold throughout the western United States (Heiner, Tr. 306-8). Kaiser acquired these mines through the stock acquisition and around 1952 disposed of them (Heiner, Tr. 368-9; 405). It is sales of commercial non-coking coal from these mines which were made in 1951 and 1952. Thus the sales referred to are not sales of coking coal at all. Since counsel who prepared the appellate brief were not present at the trial, it is likely that counsel were unaware of these facts and did not realize the statements are inaccurate and misleading. All of the cases have recognized that there is a distinction of commercial substance between coal of coking and non-coking quality and that prices for coal *not* suitable for coking cannot establish a price for coking coal. *Alabama By-Products Corp. v. Patterson,* 258 F.2d 892 (5th Cir. 1958).

C. Failure of District Court to Utilize Raton Coking Coal Transactions.

Kaiser is *not* in agreement that those sales by Raton Coal Company to Colorado Fuel and Iron Corporation, which were arm's length transactions between a seller of coking coal and a direct consumer for the purpose of producing metallurgical coke, should only be *considered* and that they "*confirm* . . . sales prices obtained by Utah Fuel Company" (Finding 71, R. 50). On the contrary, these Raton prices establish the basis for a representative market price (as adjusted by normal commercial practice) and *must be used* for that purpose. The Court did not use them. (Kaiser's Brief, pp. 51-53). The Government does not dispute this and has no answer for it. This is clearly reversible error.

The Government attempts to minimize taxpayer's position that the sales by Raton Coal Company to Colorado Fuel & Iron are the ones which must be used for the purpose of arriving at a representative market price for Kaiser's Sunnyside coal upon the basis

that other sales were made by Raton Coal Company which should also be used. It is, of course, true that such other sales were made. However, the sales to Colorado Fuel & Iron were to a direct consumer and were the only sales of coal for coking purposes other than the test sales to Sheffield and Kaiser Steel in the years in question. The sales to Colorado Fuel & Iron aggregating approximately 1,600,000 tons represent more than two-thirds of the tonnage sold by Raton in the years 1948, 1949 and 1950. Of the remaining sales approximately one-half were made to the Santa Fe Railroad another direct consumer, for non-coking purposes. The approximate 200,000 tons sold by Raton in the years in question to "retail dealers" were at prices which were approximately one-half of those realized on the sales to Colorado Fuel & Iron and the Santa Fe Railroad. These "dealer" sales were for commercial purposes and the price obviously reflects the same deficiencies in coking coal for domestic uses as was found to be the case by Utah Fuel Company. They were also sales made in an entirely different market to "retail dealers" at wholesale prices which are far less than those realized on sales to a direct consumer. This is self evident from the prices set forth in Finding 65 (R. 48). The coal produced from the Kaiser Sunnyside mines was "sold" to Kaiser Steel, a direct consumer, for use in its blast furnaces. It is this coal for which we are seeking a "representative" market price. The price for coking coal for this type of use is clearly reflected and established by the Raton sales to C.F.&I. The teaching of the *North Carolina Granite Corp.* case (supra) is clearly to the effect that a wholesale price for coal for a use for which it is not suitable cannot be "representative" of a price to a direct consumer for a use for which it is directly suited.

Finally, there is no reason suggested in the record to disregard the transactions in Oklahoma-Arkansas coal. The District Court said that this coal was not of like kind and grade as the Sunnyside coal. The only difference, however, is that the so-called low volatile coal has more fixed carbon and less volatile matter than the high volatile coal. (Finding No. 56, R. 46). For that matter the Sunnyside coal has more fixed carbon than the Raton coal, (compare

Finding No. 59, R. 46 and Finding No. 66, R. 49) but that fact does not render these two coals of differing kind and grade on the basis of the Court's own findings. Similarly, a mere difference in fixed carbon content should not constitute the Sunnyside coal a different kind and grade from the Arkansas-Oklahoma coal. Therefore, prices established for the Arkansas-Oklahoma coal in open market transactions should be considered along with the prices for the Raton coal in establishing a representative market price for Kaiser's Sunnyside coking coal. The Government's attempt to dismiss the Oklahoma-Arkansas coal as a mere "additive" is simply a play on words. Both coals are utilized in producing coke for the blast furnace, neither could be used alone to make a satisfactory coke (Finding 60 and 61, R. 46-47), and both are of equal importance in the coking process.

D. Adjustments to the Raton Price.

The recognized commercial adjustments necessary in order to arrive at a representative market price for the Sunnyside coal were not applied to these Raton prices and were rejected by the District Court. The prices obtained in those transactions must be viewed in the light of the fact that the Raton coal was sold unwashed and that even when washed it had a higher ash content than the Sunnyside coal. The reason these factors must be considered in establishing a representative market price is because the market itself considers such factors in establishing a price. The uncontradicted testimony in this regard was reviewed in detail at pp. 55-58 of Kaiser's Brief. All of the decided cases to date have distinguished between washed and unwashed coal in determining prices. No answer is made by the Government to this point. The District Court properly found that the most important factor in coking coal is the amount of the fixed carbon. (Finding No. 54, R. 45). The uncontradicted testimony also establishes that it is the most important factor in *pricing* coal. No finding was made by the Court on this point. Coal with less ash has more fixed carbon and therefore sells for a higher price. The representative market price of coal with more fixed carbon (and less ash) is higher than the

representative market price for coal with less fixed carbon (and more ash).

The Government does not appear to dispute the propriety of these adjustments. Instead it tries to dissipate the significant effect of these most important factors, i.e., a washed coal with higher fixed carbon, by arguing that the Court found there were other factors which made the Raton coal as desirable and therefore "resulted in a 'standoff' between that coal and Sunnyside coal" (Government Brief, p. 50). The record simply does not support this contention.

The Trial Court did not find there was any "standoff". It found only that "the advantages . . . *minimize* . . . the differences" (Finding 69, R. 50). Even this finding has no support in the record.

It is contended that the Raton coal had greater plasticity and that this factor gave it an advantage with respect to the Sunnyside coal. Be this as it may, the Government's own witness testified that he "couldn't put any dollar value" on the effect of plasticity on price (Johnson, Tr. 1002) and that so far as plasticity goes high volatile coals "all sell at the same price" (Johnson, Tr. 1012). The positive testimony is that plasticity is "not recognized" in the price of coal (Keenan, Tr. 290). Of equal significance is the fact that the Government's witness, Johnson, who expressed his personal opinion as to the coals being "about a standoff" (Tr. 1001), had testified earlier on direct in the same series of question that he had *not* arrived at any conclusion concerning the relative value of the two coals based on ash, sulphur and plasticity because he could not "dollarize" the effects of plasticity (Tr. 996-997).

It is also argued that the factor of sulphur would result in a market price lower than that being contended for by the taxpayer. In support of this contenton, reference is made to the testimony of the witness Heers. While it is the fact that Heers testified to a 5¢ to 10¢ per ton difference in value for each 1/10th of 1% sulphur difference, this testimony was given in the context of an overall appraisal of differences in prices. At the same time, Mr.

Heers testified that there is a 30¢ to 40¢ difference in price per unit of ash and that the Sunnyside coal was 11 points better than the Raton coal. The net effect of such an adjustment obviously would be well in excess of that for which the taxpayer is contending. It should also be remembered that the uncontradicted testimony of Mr. Keenan (Tr. 273) is that in western practice any sulphur content under 1% is of no concern to the buyer.

Finally, it should be noted that the Government's own witness, Johnson, testified that the differences in ash and sulphur between the Sunnyside and Raton coals would result in a 60¢ to 70¢ difference in favor of the Sunnyside coal (Tr. 971). The witness own worksheet (Pl. Ex. 41) shows that these differences were $1.65 in 1949 and 58¢ to 69¢ in 1950. When he was asked to consider the fact that in addition one coal was washed and the other unwashed, he testified that this "might make around a dollar difference" (Tr. 1020). Thus, if we are to use the Government's own testimony in this connection for the purpose of making the adjustments due to the recognized commercial differences, we would have a minimum adjusted price of $6.94 for 1949 and $7.03 for 1950, based on the sales prices from Raton Coal Company to Colorado Fuel & Iron (Appendix G, Kaiser's Brief). Contrary to the Government's claim, the taxpayer's dollar figures are not only clearly supported but are less than the amounts that would be arrived at by using the Government's own testimony.

V. CONCLUSION

The principal errors of the District Court lie in its failure to observe the legal standards applicable to the facts. The case should be returned to the District Court for correction of these errors.

As to the iron ore, the District Court should be directed to determine a representative market price based upon (a) Lower Lake Port ore prices, (b) an adjustment of these prices for those pricing factors recognized in commercial practice (i.e., for iron content), and (c) the establishment of a mine price *at Kaiser's mine* by deducting from the market price at the point of sale the

freight from Kaiser's mine to such point of sale. The mine prices realized by Utah Construction Company in Utah for its iron ore transactions do not meet the standard of establishing representative market prices for Kaiser's iron ore in California. The only such prices which possess even some of the indicia of being representative are the export sales at Long Beach.

As to the coking coal, the District Court should be directed to determine a representative market price based upon (a) the prices realized on the sales of the Raton coal to Colorado Fuel and Iron Corporation, (b) adjustment of these prices to reflect the recognized commercial pricing factors of ash content and washing operations, and (c) an averaging of the resultant adjusted price with the prices realized on the arm's length sales of Oklahoma-Arkansas coking coal. The sales of coal by Utah Fuel Company at distress prices for non-coking use and the minimal volume of accommodation sales by Kaiser do not meet the standard of establishing representative market prices for the coking coal mined by Kaiser.

Dated: June 10, 1968

Respectfully submitted,

George E. Link
Edward J. Ruff
Fielding H. Lane
Thelen, Marrin, Johnson & Bridges

By Edward J. Ruff

Attorneys for Appellant

VI. CERTIFICATE OF ATTORNEY

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Edward J. Ruff

Attorney

No. 22274

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

FRANK A. EYMAN, SUPERINTENDENT
ARIZONA STATE PENITENTIARY,

APPELLANT

-vs-

ROBERT ALFORD,

APPELLEE

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF ARIZONA

BRIEF FOR APPELLANT

JERRY L. SMITH
ATTORNEY FOR APPELLANT

FILED

WM. B. LUCK, CLERK

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IN THE UNITED STATES COURT OF APPEALS

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No. 22274

EYMAN, SUPERINTENDENT ARIZONA
STATE PENITENTIARY,

APPELLANT,

-vs-

ROBERT ALFORD,

APPELLEE.

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF ARIZONA

BRIEF FOR APPELLANT

JURISDICTIONAL STATEMENT

Appellant, Frank Eyman, Superintendent of the Arizona State Penitentiary, is before this Honorable Court on appeal from an Order granting Writ of Habeas Corpus by the United States District

Court for the District of Arizona, The Honorable C. A. Muecke presiding.

The Appellee, ROBERT ALFORD, is now imprisoned in the County Jail of Coconino County, in Flagstaff, Arizona, pursuant to the Order of the Honorable C. A. Muecke entered on the 30th day of June, 1967; that this Order was subsequently modified by an Order being entered on the 10th day of August, 1967, staying the Writ of Habeas Corpus until the determination of the Appeal from said Order.

The appellee was charged with three (3) counts of First Degree Murder by Criminal Complaint on the 16th day of July, 1963 to which he first entered a plea of not guilty on the 30th day of July, 1963 by and through his attorney, JOHN H. GRACE; said plea being subsequently changed to guilty on the 20th day of September, 1963; The appellee was adjudged guilty on his plea by the Honorable

Laurance T. Wren, Judge of the Superior Court of Coconino County, and was sentenced to be executed. Appellee exhausted his appeal remedies by appeal to the Arizona Supreme Court, and by application for Writ of Certiorari to the Supreme Court of the United States.

The proceedings before the Arizona Supreme Court resulted in affirmation of appellee's conviction and sentencing, State of Arizona vs. Alford, 98 Ariz. 124, 402 P.2d 551, and Motion for Rehearing, State vs. Alford, 98 Ariz. 249, 403 P.2d 807, denied June 29, 1965.

Application for Writ of Certiorari to the Supreme Court for the United States was made June 28, 1965, and on January 24, 1966, the United States Supreme Court (Alford vs. Arizona, No. 481 misc. Oct. Term, 1965) entered the following Order:

"The Petition for Writ of Certiorari is denied. Mr. Justice Douglas is

of the opinion that it should be granted."

Jurisdiction of the United States District Court for the District of Arizona was invoked by reason of 28 U.S.C.A. 2241 (c)(3).

The United States District Court for the District of Arizona granted ROBERT ALFORD'S Petition for Habeas Corpus on the 30th day of June, 1967, in Phoenix, Arizona.

Notice of Appeal of the granting of Habeas Corpus was filed on the 27th day of July, 1967, in the United States District Court for the District of Arizona, in Phoenix, Arizona.

STATEMENT OF FACTS.

On June 6, 1963, the bodies of three victims, their names, Carol Ann McCain, Jacqueline Walker and Theodore Walker, all being minor children were found approximately one mile South of Highway 66, near

Williams, Arizona. The initial investigation revealed Carol Ann McCain had been shot four times, Jacqueline Walker and Theodore Walker had each been shot twice. In addition Carol Ann McCain had been beaten severly around the head.

Thereafter the defendant, petitioner herein, was developed as a suspect, and was arrested on July 12, 1963, at Santa Rosa, California. That the petitioner was arrested at 4:45 p.m. by Lt. Robert Hays of Sonoma County Sheriff's Office along with Ron Stamp of the Federal Bureau of Investigation.

The petitioner, at this time, was advised of what he was being arrested for, and further advised that he did not have to make a statement, who the officers were, and was then taken into custody. No statements of any kind were taken at this time. The defendant was then transported to the Sonoma County

Jail, Santa Rosa, California, whereupon he was booked and fed.

At approximately 10:00 p.m., on July 12, 1963 an F. B. I. Agent, by the name of John Huber, interviewed this defendant and advised him of his rights in the following manner. (See Transcript of District Court Hearing, November 22 and 23, 1966, hereinafter referred to as T., pages 140 and 141):

1. That any statement the petitioner would give had to be voluntary.

2. That said statement could be used against him.

3. That John Huber would testify against him; that he petitioner had the right to an attorney at the time of the interview, and there was a telephone on the desk which he could use to call an attorney.

4. That if he could not afford an attorney he could have one through the public defender's office.

5. Mr. Huber further advised that he would not threaten or abuse him, and that he had a right to

remain silent and could walk out and go back to his cell at that time.

6. That Mr. Huber advised the defendant of the nature of the investigation and of the charges to be filed against him.

7. That Mr. Alford did not want an attorney.

The interview lasted approximately one and one-half hours. Thereafter a polygraph examination was given to the petitioner, at petitioner's request, on the 13th day of July, 1963. On July 16, 1963, at 1:30 p.m., again defendant having been advised of his rights, as heretofore stated, the defendant gave to Mr. John Huber and Clarence Cole, a statement in which he confessed to the killing of three victims, Carol Ann McCain, Jacqueline Walker and Theodore Walker.

The petitioner signed a Waiver of Extradition at approximately 5:00 p.m. on July 16, 1963, only after being advised of his rights at that time by

a municipal judge.

At the time the petitioner was taken into custody he was not indigent in that he had $435.00 on his person plus an unencumbered pickup-camper. The petitioner was returned to Flagstaff on July 16, 1963, at which time he was taken before the Justice of the Peace, James F. Brierley, who advised him of his right to have an attorney, the charges against him, and right to a preliminary hearing.

The defendant, petitioner herein, was brought before the Justice of the Peace on the 18th day of July, 1963, on the 20th of July, 1963, and on the 22nd day of July, 1963, at which time a preliminary hearing was conducted. Mr. Alford either refused or would not hire an attorney to represent himself at the preliminary hearing even though he was not indigent. The preliminary hearing was conducted and defendant, petitioner herein, was

[illegible]

bound over for trial in the Superior Court of the State of Arizona in and for the County of Coconino.

An information was filed on July 28, 1963, and on July 30, 1963, defendant appearing in person and with his employed counsel, John H. Grace, and entered a plea of "*not guilty*". (Emphasis supplied). Trial by jury was set for September 23, 1963, at 9:30 a.m. A time for hearing as to the mental ability of the defendant to stand trial for three counts of murder was set for September 20, 1963, and on said date defendant appeared in person and with his attorney, John H. Grace.

The defendant was examined by a competent psychiatrist, Dr. Maier I. Tuchler, and a psychologist, Dr. Canter, both of whom determined him to be legally sane and fully able to cooperate and assist his attorney in his defense.

Dr. Meier I. Tuchler was sworn to testify on October 1, 1963, pursuant to Rule 250, and stated that defendant's mental ability was such that he was able to stand trial and assist counsel in his defense. Defendant thereupon moved the Court to withdraw his plea of not guilty, theretofore entered as to each of the counts against him. Motion was granted. Thereupon, the defendant herein entered his plea of guilty as to Counts I, II and III as charged in the information. This was done as follows:

"MR. GRACE: May it please the court, in view of the doctor's testimony, at this time the defendant withdraws his plea and enters a plea of guilty.

THE COURT: This is as to all three counts, Mr. Grace?

MR. GRACE: Yes, Your Honor.

THE COURT: I would like to have the defendant himself enter these pleas.

MR. GRACE: Yes, Your Honor.

THE COURT: Will the defendant stand, please?

(the defendant does so)

Mr. Grace, you are requesting permission from the court to withdraw the pleas of not guilty heretofore entered before the court. Is that correct?

MR. GRACE: Yes, Your Honor.

THE COURT: Very well, it is ordered that the defendant is granted permission to withdraw the pleas of not guilty entered to each count on July 30th and entered in this record.

And it is your desire at this time, Mr. Grace, to have your client enter another plea. Is that correct?

MR. GRACE: Yes, your Honor.

THE COURT: Mr. Alford, is it your desire, as your counsel has stated, to withdraw your pleas of not guilty heretofore stated?

THE DEFENDANT: Yes, Your Honor.

THE COURT: Will you waive specifically the reading of the information, Mr. Grace, as you did heretofore?

MR. GRACE: Yes, Your Honor.

THE COURT: Mr. Alford, what is your plea, then to the charge that you did wilfully, feloniously deliberately, and with premeditation and malice

aforethought kill, to wit, murder in the first degree, Jacqueline Walker, a human being? What is your plea: Guilty or not guilty?

THE DEFENDANT: Guilty.

THE COURT: And what is your plea to the charge as stated under Count 2 of the information, that you did commit murder in the first degree upon the person of Theodore Walker, a human being? Guilty or not guilty?

THE DEFENDANT: Guilty.

THE COURT: And under Count 3 you are charged with murder in the first degree of Carol Ann McCain. What is your plea that charge: Guilty or not guilty?

THE DEFENDANT: Guilty.

THE COURT: Let the record note the defendant has entered a plea of guilty to each of the three counts stated in the information.

I would much have preferred that this matter, whether this man lives or dies, be placed before a jury of twelve men and women. It is something that I want substantially more than a few days to decide. I will set this matter for sentencing on October -- (the court consults the calendar) I will set it on October 7th at 10 o'clock in the morning. I know our calendar is clear on that day. In the meantime, the defendant will be remanded to the

custody of the Sheriff's Office, where he will again be held without bail.

I would like the County Attorney's Office, in the meantime, to submit to me a full written report within the next week on the evidence that they intended to introduce at this trial and what they sincerely believe to be the facts of this case. I will designate that before this report is filed, it be exhibited to Mr. Grace for his approval or disapproval either as to the whole or any specific parts thereof. And, Mr. Grace, you may likewise within the next week submit a written report, if you desire, and likewise exhibit a copy to the County Attorney's Office.

If there is nothing further, then, from the defense or the State, we will stand adjourned.

Anything further?

MR. GRACE: No, Your Honor." (R.T., pp. 19-22, at Hearing on October 1, 1963)

The date for the trial had been set for September 23, 1963, at 9:30 a.m., and on that date the State of Arizona had some 35 witnesses, with 22 being from out of state, ready to go to trial. Counsel for the defendant was well aware of these

witnesses and the evidence to be presented against Mr. Alford and as a consequence of the September 20th hearing and the overwhelming evidence against the defendant, the defendant changed his plea from not guilty to guilty.

That counsel for the defendant did not request the court, pursuant to Rule 336, for a mitigating or aggravating circumstance hearing, however, the court, upon it's own, conducted an investigation and inquired into all the circumstances surrounding this crime as is shown by the total record made to date.

On October 7, 1963, this being the time set for passing of sentence, defendant appeared in person and with attorney, John H. Grace. The defendant, at the last moment, asked the court to withdraw his plea of guilty on all three counts heretofore entered. The defendant's request to

withdraw his plea of guilty was denied. It was the judgment of the court that defendant was guilty as charged, and it was ordered by the Honorable Laurance T. Wren, Judge, that he be punished on each of the three counts, by being executed, in the manner prescribed by law, on December 13, 1963, at the Arizona State Prison, Florence, Arizona.

That at the hearing on the Writ of Habeas Corpus before this Honorable Court, held on November 22nd and 23rd, 1966, Mr. John H. Crece, defense counsel for defendant, Robert Alford, testified that with the great number of witnesses available to the State of Arizona, the lack of an insanity defense, the confession and numerous conflicting statements subsequently given by the defendant after his confession and thorough investigation of the case and numerous interviews with the defendant, he felt that he could do

nothing else but advise his client to change his plea from not guilty to guilty and throw his client upon the mercy of the Court. (R.T.W.H. in U. S. Dist. Ct. p. 73 and p. 88). This decision was made by an experienced defense attorney who has defended some six murder cases, plus having a fine reputation in the County of Coconino as being an experienced defense attorney. In addition, the defense counsel was furnished extensive investigative help through the County Attorney's Office, the F. B. I., and the Sheriff's Office in the preparation of his case (T. pp. 118, 144, 145, 153, 154, 187, 188, 190).

That at the time of sentencing conducted on October 7, 1963, the prosecution presented to the Court in a pre-sentence report a complete review of the case that was to be presented to the jury, defense counsel presented an extensive

presentence report and the Court, on its own, conducted a very extensive presentence investigation.

This is born out by the Reporter's Transcript of proceedings conducted October 7, 1963, pages 33 and 34 and pages 36 through 44 which are very noteworthy, as follows:

> "Mr. Alford, never has this court made a harder decision than the one that I have to make now. I want you to know that I have spent many days and some sleepless nights, and that I have studied every angle and every possible facet. The reports, I have gone through time and time again, as I indicated to you. Like every Christian, Mr. Alford, I have a deep and abiding faith in the existence of God, and I have always felt that the taking of a human life is something that is best left to accident and the will of God. But in considering that factor, I realize full well that we are not here concerned with vengeance. We are concerned with the law that gives us two choices, and the law which states that I should select one of those alternatives on the basis of the facts that you yourself have created. My decision in this particular case would be an easy one, if by taking your life I could restore the life

of just one of the children whom you have killed. But this is not possible. I know that my decision will draw criticism, whichever way I decide; and I have earnestly tried to ignore this factor and to judge this matter solely upon the merits and what little wisdom I might possess. I was impressed by the report that your attorney filed in this matter on your behalf, and I would like for you and for the courtroom to hear the last paragraph of it.

(reading)

I trust that my thoughts stated herein will aid the court in reaching its decision as to the sentence to be imposed upon Mr. Alford, and I feel that whatever the sentence is, the Court will be fully advised of all aspects of the case and will reach a decision, in pronouncing this sentence, which will be true justice for my client and for society.

(end reading)

In making a decision in this case Mr. Alford, I considered many factors. For your benefit and the benefit of the people in this courtroom, I would like to enumerate some of them. One is my deep respect for your attorney. He has discussed this matter with me many times. As I indicated to you a while ago, I am sure he entered this plea -- in fact, I know that he entered this plea with the hope that I would impose upon you a light sentence. As I indicated, he was dead certain, as I am dead certain that a jury carefully selected by the County Attorney's Office, carefully questioned as to the death penalty,

would impose upon you the sentence of death. Less than four years ago in this very courtroom the jury sentenced a man to death for a crime that I consider to be less horrible than yours. I cannot understand, Mr. Alford, what possesses a man, that he can kill three defenseless children; that he can methodically, after shooting them, walk around to each of the bodies and place another bullet through the heart of each, while they are lying dead or dying on the ground, and how he can then beat one of them over the head with the butt of the pistol until the grip breaks. It is beyond my comprehension. In going over the facts of this case, you made me realize the full import of the words "man's inhumanity to man." I did not learn of this, this factor, of this case, until after you entered your guilty plea and I discussed the matter with the investigating officers, in attempting to find out what all the facts in this case were, in order that I could arrive at what I felt to be a just decision. As I stated, I did not until then learn of the fact that beneath each of the bodies they found a 45 caliber bullet on the ground. I was so distrubed by this fact that I called Dr. Tuchler, in Phoenix, the psychiatrist who testified at your insanity hearing. I read to him from the reports describing the finding of these bullets, and I asked him, "could this possibly be the act of a man in a rage; could this be the act of a man with a mental deficiency, with mental disorders, or a man with

[illegible]

sexual problems," all of which he described and touched upon in his testimony and in his written report. He replied to me very emphatically, no, that what he stated about the rule on insanity, the Durham Rule, had no application to this fact. He stated that this was the act of a cold, calculating mind, anxious to destroy anyone who might later testify against him in court.

In regard to his report (to which the court now refers), I would at this time like to go over two or three factors that he mentioned in it. This court is fully considering the fact that you have had mental problems in the past, in regard to your unnatural sex desire for young children, girls. Dr. Tuchler, who is one of the finest criminal psychiatrists in this state, indicated that your memory, recall and recollection appear intact, as the past history lucidly demonstrated. He goes on to state that consistent throughout your story is a role that you wish to present: a man who loves children. "As a psychatric entity, it is common," he states, "to find men more or less sexually inadequate attaching themselves to younger children by kindly acts which often disguise sexual wishes." He stated that you were alert and of good intelligence; that the only areas in which your memory appears to be deficient are related to the significant days in question, during which three children disappeared and were later found as victims of a homicide. During this period, you allege amnesia, although during the first day of the interview, you reported

a slightly different version of events. He then goes on to state, finally, "I look upon this alleged amnesia as a fabrication."

(end reference to report)

Again going back to the investigative reports, I note that when you confessed to this crime in California and you admitted firing the first shot at one of the children who was running, that you could not recall what happened from then on; that you blacked out. I also brought out this proposition to Dr. Tuchler; and if there was anything that he was emphatic about, it was the fact that there could be no amnesia in your case, that you could recall each and every of these events very closely if you would care to bring them forward. He was extremely emphatic about that. Amnesia could not be present in your type of case. He said that the details of your past life would indicate this, as well as the details leading up to the actual events.

(the court again refers to the doctor's report)

He goes on to state that the subject is well able to understand the nature and the quality of the cause for which he is charged, and is able to assist counsel in his defense; and concludes by stating that you are fully competent in the medical and in the legal sense.

(end reference)

As I indicated, I asked him about the firing of the 45 bullets, under the Durham Rule. And he said this would not fit the Durham Rule; that it was not any mental deficiency that caused the firing of

the 45, in spite of the initial shooting -- or regardless of the initial shooting of the 32 pistol, I believe.

After you entered your guilty pleas, I discussed the California investigation with the FBI men, four or five of them who were here to testify at your trial. I also looked over the reports submitted by the County Attorney's Office, the Sheriff's Office, Dr. Tuchler, Dr. Canter, and I studied the photographs of the children that were taken at the scene and at the mortuary. I could not then and I cannot now think of a single angle that I did not consider.

Mr. Alford, at this time, when your race is looking for a brighter place in the sun, you commit an act that gives them a great setback, one so horrible that it shocks the senses. As you know, the law leaves me two alternatives, life imprisonment or the death penalty. In considering the sentence of life imprisonment, I considered the fact that you could very possibly be paroled from the State Prison in about ten years. And in considering this possibility of parole, I look at your previous history of criminal acts and I will state to you that it is not a pretty one. In 1930, in Lincoln, Nebraska, you were given one year for breaking and entering. Again in 1930, in Council Bluffs, Iowa, you were sentenced for illegal transportation of liquor. McAllister, Oklahoma, 1935, you were given a five-year sentence for larceny of livestock. In 1943, Plymouth, Michigan, you were charged

[illegible]

[illegible]

[illegible]

with assault. California, San Joaquin County, in 1958, lewd and lascivious conduct. The record also states that you have had other arrests for vagrancy, prowling, statutory rape, larceny, and molesting. Somehow, Mr. Alford, the thought of you again being free in society leaves me cold.

Mr. Alford, the very seriousness of your crime, the very brutal fashion of it, leaves me no choice. Other people who would commit such an act must know that if they do so, they shall forfeit their own life. With no apology except to your attorney, it is the judgment and sentence of this court that as to each of the three counts in the information that you be forthwith confined to the Arizona State Prison, at Florence, Arizona, and there that you be executed in the manner prescribed by law. The date of the execution, I am fixing as of December 13 of this year.

I will say to you, May God have mercy on your soul, and on mine if I have done a wrong.

And there the matter rests." (R.T. of Sentencing, Oct. 7, 1963, pp. 36 to 45)

CONSTITUTIONAL PROVISIONS INVOLVED

The Constitutional Provisions involved in this case is the Sixth Amendment to the Constitution of the United States:

AMENDMENT VI: "In all criminal prosecution, the accused shall enjoy the rights to a speedy and public trial, by an impartial jury of the State and District wherein the crime shall have been committed, which district shall have been previously ascertained by law, and to be informed of the nature and cause of the accusation; to be confronted with the witnesses against him; to have compulsory process for obtaining witnesses in his favor, and to have the Assistance of Counsel for his defense."

and, the Fourteenth Amendment to the Constitution of the United States:

AMENDMENT XIV: "Section 1. All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

SPECIFICATION OF ERRORS RELIED UPON

1. That the Honorable C. A. Muecke, Judge of the District Court, in and for the

District of Arizona, erred in granting the Writ of Habeas Corpus upon the ground that the Trial Judge, the Honorable Laurence T. Wren had erred in failing to give the defendant the right to confront and cross-examine witnesses in a presentence proceedings and sentence proceedings all in violation of the Sixth Amendment to the Constitution of the United States.

2. That the Honorable C. A. Muecke, Judge of the District Court, in and for the District of Arizona, erred in granting the Writ of Habeas Corpus upon the ground that the Trial Judge, The Honorable Laurence T. Wren, abused his discretion in failing to allow the defendant, Robert Alford, appellee herein, to withdraw his plea, so as to amount to a violation of due process under the Fourteenth Amendment to the Constitution of the United States.

3. That the U. S. District Court for the

District Court, in and for the District of Arizona erred in failing to follow the Doctrine of Stare Decisis.

QUESTIONS PRESENTED

1. Whether or not defendant appellee herein, was denied the protection of the Sixth Amendment to the Constitution of the United States by not having the right to confront and cross-examine witnesses in presentence proceedings and sentence proceedings.

2. Whether or not it was a violation of due process under the Fourteenth Amendment to the Constitution of the United States for the Trial Judge's failure to allow the defendant, Robert Alford, appellee herein, to withdraw his plea.

3. Whether or not the Honorable C. A. Muecke erred in failing to follow the doctrine of Stare Decisis.

A R G U M E N T

1. WHETHER OR NOT DEFENDANT, APPELLEE [illegible], WAS DENIED THE PROTECTION OF THE SIXTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES BY NOT HAVING THE RIGHT TO CONFRONT AND CROSS-EXAMINE WITNESSES IN A PRESENTENCE PROCEEDINGS AND SENTENCE PROCEEDINGS.

The Sixth Amendment to the Constitution of the United States reads as follows:

> <u>AMENDMENT VI</u>: "In all criminal prosecution, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and District wherein the crime shall have been committed, which district shall have been previously ascertained by law, and to be informed of the nature and cause of the accusation; to be confronted with the witnesses against him; to have compulsory process for obtaining witnesses in his favor, and to have the Assistance of Counsel for his defense."

It is very plain and evident from reading the Sixth Amendment that this amendment applies only to trial procedure. The defendant, appellee herein, had plead guilty to the charges contained in the

information, therefore there is no issue to the appellee's right to a speedy and public trial by an impartial jury. Therefore, the Sixth Amendment has no application to presentence proceedings and sentence proceedings after a plea of guilty had been entered by the appellee herein. It would follow that he would have no right to confront and cross-examine witnesses as guaranteed by the Sixth Amendment at a presentence and sentence proceedings.

As far as the undersigned can determine, the case of Williams v. N. Y., 337 U. S. 242 (1949), is the leading case on the subject and is almost on all-fours with the question presented herein. The Trial Judge in the Williams case, supra, refused to follow the jury's recommendation of a life sentence and imposed the death sentence. The U. S. Supreme Court in an opinion delivered by Mr. Justice Black affirmed the judgment with the following

comment:

"Tribunals passing on the guilt of the defendant always have been hedged in by strict evidentiary procedural limitations. But both before and since the American colonies became a nation, courts in this country and in England practiced a policy under which a sentencing judge could exercise a wide discretion in the sources and types of evidence used to assist him in determining the kind and extent of punishment to be imposed within limits fixed by law. Out-of court affidavits have been used frequently, and of course in the smaller communities sentencing judges naturally have in mind their knowledge of the personalities and backgrounds of convicted offenders. A recent manifestation of the historical lattitude allowed sentencing judges appear in Rule 32 of the Federal Rules of Criminal Procedure. That rule provides for consideration by federal judges of reports made by probation officers containing information about a convicted defendant, including such information "as may be helpful in imposing sentence of, in granting probation or in the correctional treatment of the defendant. . . ."

A sentencing judge, however, is not confined to the narrow issues of guilt. His task within fixed statutory or constitutional limits is to determine the type and extent of punishment after the issue of guilt has been determined. Highly relevant - if not essential - to his selection of an appropriate sentence is the possession of the fullest information possible concerning the

defendant's life and characteristics. And modern concepts individualizing punishment have made i all the more necessary that the sentencing judge not be denied an opportunity to obtain pertinent information by a requirement of rigid adherence to restrictive rules and evidence properly applicable to the trial."

"Modern changes in the treatment of offenders make it more necessary now than a century ago for observance of the distinctions in the trial and sentencing processes. For indeterminate sentences and probation have resulted in an increase in the discretionary powers exercised in fixing punishments. In general, these modern changes have not resulted in making the lot of offenders harder. On the contrary a strong motivating force for the changes has been the belief that by careful study of the lives and personalities of convicted offenders many could be less severly punished and restored sooner to complete freedom and useful citizenship. This belief to a large extent has been justified."

"Under the practice of individualizing punishments, investigational techniques have been given an important role. Probation workers making reports of their investigations have not been trained to prosecute but to aid offenders. Their reports have been given a high value by conscientious judges who want to sentence persons on the best available information rather than on guess-work and inadequate information."

"To deprive sentencing judges of this kind of information would undermine modern penological procedural policies that have been cautiously adopted throughout the nation after careful consideration and experimentation. We must recognize that most of the information now relied upon by the judges to guide them in the intelligent imposition of sentences would be unavailable if information were restricted to that given in open court by witnesses subject to cross-examination. And the modern probation report draws on information concerning every aspect of a defendant's life. The modern type and extent of this information make totally impractical if not impossible open court testimony with cross-examination. Such a procedure could endlessly delay criminal administration in a retrial of collateral issues."

"It is urged, however, that we should draw a constitutional distinction as to the procedure for obtaining information where the death sentence is imposed. We cannot accept the contention. Leaving a sentencing judge free to avail himself of out-of-court information in making such a fateful choice of sentences gives to him a broad discretionary power, one susceptible of abuse. But in considering whether a rigid constitutional barrier should be created, it must be remembered that there is possibility of abuse wherever a judge must choose between life imprisonment and death. It is conceded that no federal constitutional objection would have been possible

if the judge here had sentenced appellant to death because appelland's trial manner impressed the judge that appellant was a bad risk for society, or if the judge had sentenced him to death giving no reason at all. We cannot say that the due-process clause renders a sentence void merely because a judge gets additional out-of-court information to assist him in the exercise of this awesome power of imposing the death sentence."

It is interesting to note that in State v. Fenton, 341 P.2d 237, 86 Ariz. 111, certiorari denied. 4 L.Ed2 115, co-counsel for appellant, Mr. Ed Morgan, attempted to have United States Supreme Court grant certiorari. Our Arizona Supreme Court in the Fenton case stated that a trial court at a presentence hearing is not bound by the strict laws of evidence applying in trials, and that the Trial Judge should have all the information possible as to the accused's past conduct. (Emphasis supplied.)

"We are of the opinion that Rule 336, should be given a broad interpretation, and that the "circumstances"

> mentioned therein do not limit the trial court to only a consideration of the mitigating or aggravating circumstances of the offense charged. State v. Owen, 73 Idaho 394, 253 P2 203.

In 1960, in the case of United States of America v. Henry Durham, 181 F. Supp. 503, Judge Holtzoff made the following statements in rendering his decision.

> "It is not the practice to permit the defendant or his counsel or any one else to inspect records of pre-sentence investigations. Such reports are treated as confidential documents. They are not public records. The reason is obvious. Such reports in order to be helpful to the Court, must of necessity contain a considerable amount of information that may be obtained, on occasion in confidence, so, too, the Probation Officer must feel free to make comments and suggestions that may prove to be of value to the Court."
>
> "Rules of evidence are not applicable to the imposition of sentence. In fact, it has been the traditional practice, even before the system of presentence investigations was introduced, for the Court to receive information in confidence which the Court might or might not disclose to the defense, as the Court saw fit, that might bear upon the question of what sentence should be imposed. The custom of treating reports as confidential documents is

[illegible]

merely a continuation of the prior practice. If these reports were made public and were available to counsel as a matter of right, I am sure that their value would be much reduced, because a great deal of information now generally contained in them would not be available."

2. WHETHER OR NOT IT WAS A VIOLATION OF DUE PROCESS UNDER THE FOURTEENTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES FOR THE FAILURE OF THE TRIAL JUDGE TO ALLOW THE DEFENDANT, ROBERT ALFORD, APPELLEE HEREIN, TO WITHDRAW HIS PLEA.

Rule 188 of the Arizona Rules of Criminal Procedures provides as follows:

"The Court may in its discretion at any time before sentence permit a plea of guilty to be withdrawn, and, if judgment of conviction has been entered thereon, set aside such judgment, and allow a plea of not guilty, or with the consent of the county attorney, allow a plea of guilty of a lesser included offense, or of a lesser degree of the offense charged, to be substituted for the plea of guilty."

This rule has been interpreted on numerous occasions by the Supreme Court of the State of Arizona. In <u>State v.</u>

Valenzuela, 98 Ariz. 189, 403 P.2d 286, (1965) (The court held that a motion to withdraw a plea of not guilty is addressed to the sound discretion of the Trial Court pursuant to Rule 188 quoted herein and in the absence of clear abuse of that discretion its ruling will not be disturbed on appeal.) State v. Jones, 95 Ariz. 4, 385 P.2d 1019 (1963); State v. Alford, 98 Ariz. 124.

State v. Alford, supra, states:

> "An experienced appraisal of the available evidence frequently indicates that the chance of a successful defense is negligible. The defense attorney may then be serving his client best by advising him to plead guilty and to bargain for the most lenient treatment possible. To counsel this strategy is not to advise inadequately, even if the expectation of leniency is subsequently disappointed." (Emphasis supplied.) Comment, Assistance of Counsel, 78 Harv. L. Rev. 1434, 1441 (May 1965). And see Monroe v. Huff 79 U. S. App. D. C. 244, 145 F.2d 249 (1944)

There is nothing in this record that would indicate the defendant was induced

by the authorities to plead guilty with the expectation of lesser punishment; the record would further reflect that Alford was fully protected by the Court at the time the Court specifically examined him regarding his change of plea from not guilty to guilty and that Alford had been fully advised by a fully experienced defense counsel in that the matter had been fully discussed between counsel and Alford.

In Rainsberger v. State, 399 P.2d 129 (Nev., 1965), the Nevada Court states as follows:

> " . . . A different complexion is cast upon claimed constitutional violations and other claims or error when, as here, a defendant charged with murder, has voluntarily and with the assistance of competent court-appointed counsel, entered a plea of guilty in open court. That procedure to ascertain the degree of the crime, and fix sentence, is within the constitutional power of a legislature to provide. <u>Hallinger v. Davis</u>, 146 U. S. 314, 13 S. Ct. 105, 36 L. Ed. 986 (1892). The court hearing, following a plea of guilty,

> is not a trial, for the issue of the defendant's guilt is no longer present (Citing cases). The constitutional safeguards pointing to a fair trial are greatly diluted in significance, for a trial to determine the ultimate issue of innocence or guilt has been waived by the plea of guilty. The presumption of innocence has ceased to exist, and the defendant stands before the court an admitted murderer, asking mercy and understanding with respect to degree and penalty. If the plea of guilty is not itself constitutionally infirm, it would appear that one who has so confessed may not rely upon the constitution to free him." . . .

See also Harris v. United States, 338 F.2d 75, 80 (9th Cir. 1964); Scott v. United States, 231 F. Supp. 360 (D. C. N. J. 1964); McKenley v. United States, 235 F. Supp. 255 (D.C.La.1964); United States v. Spada, 331 F.2d 995 (2nd Cir. 1964); Mahler v. United States, 333 F.2d 472 (10th Cir. 1964); Sninn v. United States, 343 F.2d 25 (9th Cir. 1965); United States v. Sirus, 180 F.2d 413, cert. denied 339 U. S. 986 (7th Cir. 1950).

Under the Federal Rules of Criminal

Procedure, Rule 32 (C) (1), 18 U.S.C. and Rule 32 (c)(2) provides that the defendant has no legal right to withdraw his plea of guilty (Miller v. United States, 351 F.2d 598, (9th Cir., 1965).

As outlined in the Miller case, supra, there is not the slightest indication or proof from the record, that the appellee herein, did not commit the crime charged nor is there any mistake or inadvertence on appellee's part, nor fear nor fraud nor misrepresentation practiced against him.

As is shown in the statement of facts, appellee herein, first entered a plea of not guilty. It was only after a thorough investigation by appellee's defense attorney that an application for a change of plea to guilty was made and granted by the Trial Court. It was contended in Hoover v. United States, 268 F.2d 787, (10th Cir., 1959) that the

defendant did not have an opportunity to contradict or rebut statements contained in the presentence investigation and report; however, the court held that this would not violate due process and followed Williams v. People of State of New York, supra.

U. S. v. [illegible], 366 F.2d 759, (3rd Cir., 1966), contains the following language in support of the contention that this appellee was not denied his constitutional rights under the Fourteenth Amendment to the Constitution.

> "The case comes here over well travelled ground. This court has had occasion to pass upon appeals involving points similar to those now presented upon at least four occasions. See United States v. Colonna, 3 Cir., 142 F.2d 210; [illegible] v. United States, 3 Cir., 327 F.2d 12[illegible]; Hudgins v. United States, 3 Cir., 340 F.2d 391; United States v. Washington, 3 Cir., 341 F.2d 277. The applicable principles of law are well settled. A plea of guilty is a waiver of all nonjurisdictional defects and defenses and constitutes an admission of guilt. Conviction and sentence following a

> plea of guilty are based solely and entirely upon the plea and not upon any evidence which may have been acquired by the prosecuting authorities. The plea in itself is a conviction upon which sentence may be imposed without further action of the court.
>
> "The withdrawal of a plea of guilty is not a matter of right. A motion for leave to withdraw a plea of guilty and substitute a plea of not guilty is addressed to the sound discretion of the court and should be denied if the defendant knew and understood what was being done and there were not present any circumstances of force, mistake, misapprehension, fear, inadvertence or ignorance of his rights and understanding of the consequences of his plea." <u>United States v. Colonna</u>, supra.

3. WHETHER OR NOT THE HONORABLE C. A. MUECKE ERRED IN FAILING TO FOLLOW THE DOCTRINE OF STARE DECISIS.

The case of <u>Williams v. People of the State of New York</u>, supra, has been cited to this court and it is respectfully submitted that this case is to be followed in the case now pending before this Honorable Court.

It is further submitted that the

United States District Court, for the District of Arizona, erred in failing to follow this case when construing the Fourteenth Amendment to the Constitution of the United States.

The case of Williams v. People of the State of New York, supra, although not concerned with the same legal point, was recently re-affirmed in Specht v. Patterson 18 L. Ed. 2d 326.

> "If ever there should be an adherence to former decisions, it should be in cases of construction of the Constitution involving the rights of citizens as declared by that instrument." (Cowan v. Czarnecki, 264 Ill. 305, 106 N. E. 276).

Constitutions do not change with the varying tides of public opinion and desire. (State ex rel Lemon v. Langlie, 45 Wash. 2d 82, 273 P.2d 464).

C O N C L U S I O N

The undersigned would like to point out to the Court that in No. 22249, Docket

L-159 Karl Hinos Marten, Appellant vs. Frank A. Eyman, Appellee, Mr. W. Edward Morgan is one of the attorneys for the appellant, Marten, and in this case is one of the attorneys for the appellee Alford.

Mr. Morgan in the brief for appellant, Marten, on page 29 thereof submits exactly the same argument that I have submitted to the Court herein. He agrees fully that the law allows a Trial Judge to inquire into any type of information concerning an accused's background and character.

In reviewing the Trial Court's actions and the entire record of this case, it is obvious that there was no abuse of discretion nor any denial of any basic right to due process. It is also obvious that at the time the appellee plead guilty, both the appellee and his counsel thought it was the only chance they had to save

him from a death sentence.

If the judgment of the U. S. District Court in and for the District of Arizona is upheld it would follow conclusively that all presentence proceedings become adversary in their nature. It is respectfully submitted that this is not what the U. S. Constitution and Amendments thereto intended nor would it be beneficial to any defendant convicted of a crime.

In effect, the Honorable Judge Muecke has, carte blanche, allowed this accused to admit and plead guilty to a crime, but upon the defendant hearing of some adverse fact referred to for purposes of sentencing, this is sufficient to allow an accused to withdraw his plea and admission of guilt. It is respectfully submitted that this cannot be the law.

For the reasons stated herein the undersigned earnestly requests that the order entered by the Honorable C. A.

[illegible]

Muecke be vacated and reversed.

JERRY L. SMITH
Attorney for Appellant

CERTIFICATION

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

[illegible]
Attorney for Appellant

PROOF OF SERVICE

I hereby certify that a copy of the foregoing Brief for Appellant was served upon me this _____ day of January, 1968.

[illegible]

Attorney for Appellee

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

MERVIN C. McKINNEY, Appellant, vs. JOSEPH BOYLE, EDITH WHITE BOYLE, his wife, and REBA J. BOYLE, et al., Appellees.	)	No. 22374 Misc. No. 3608

APPELLEES' BRIEF

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STATEMENT OF BASIS OF JURISDICTION

Appellees Boyle respectfully submit that this Honorable Court is without jurisdiction of this case. As appears from Appellees Boyle's motion to dismiss, which has been previously submitted and is incorporated herein by reference, final order of dismissal with prejudice was entered in this action by the court below on or about December 4, 1962. No appeal from that order has ever been taken, and the time for appeal has long since expired. On June 19, 1967, over four and a half years later, long after the one-year period prescribed by Rule 60 (b) for motions to set aside a judgment by reason of fraud, Appellant McKinney alleging fraud filed his motion to

vacate the order of dismissal. In the case of Kathe v. United States, 284 F. 2d 713, this Court held that under virtually identical circumstances, the court was without jurisdiction to set aside the judgment.

STATEMENT OF CASE

COME NOW Appellees Boyle, and pursuant to Rule 3, Rules of the United States Court of Appeals for the Ninth Circuit, controvert Appellant's Statement of the Case, and respectfully propound the following Statement of the case.

On or about April 26, 1961, Appellant Mervin C. McKinney brought suit in the court below against Appellees Boyle. Mr. McKinney was represented by the firm of Baumann & Rosengren of Scottsdale, Arizona. (A.R. 9) In his complaint, McKinney alleged that on April 7, 1961, he was in an automobile accident near the intersection of Apache Boulevard and Lebonnon Street, in Tempe, Arizona, and that at said time and place there was a collision between a 1961 rented Cadillac, which McKinney was operating, and a 1953 Ford two-door automobile, owned by Appellees Joseph and Edith White Boyle, and operated by their minor daughter, Reba J. Boyle. (A.R. 1)

On or about May 25, 1961, Appellees Boyle filed an answer to Appellant's complaint, and also filed a counterclaim against Mr. McKinney for injuries suffered by Reba J. Boyle

in the accident, and crossclaimed against Mike C. Gamboa and Mary M. Gamboa, his wife, the owners of a 1953 Ford automobile which was also allegedly involved in the accident, which vehicle was being operated by Ray M. Gamboa, a minor, their son. (A.R. 12)

On June 14, 1961, a reply to the Boyle's counterclaim was filed on Mr. McKinney's behalf by and through his attorneys, Jennings, Strouss, Salmon & Trask, of Phoenix, Arizona. (A.R. 23) Thereafter, Mr. McKinney was represented in the action not only by Mr. Rosengren, but also by the firm of Jennings, Strouss, Salmon & Trask.

On December 4, 1962, pursuant to a formal written stipulation signed not only by Appellees' counsel, but also by <u>both</u> firms of attorneys representing Mr. McKinney, the late U. S. District Court Judge, Arthur M. Davis, entered an order dismissing the case with prejudice, each of the parties to bear their respective costs. (A.R. 49) Thereafter, on or about June 19, 1967, over four and one-half years later, Appellant McKinney filed his motion to vacate and set aside the order of dismissal. (A.R. 52)

On September 11, 1967, oral argument of Appellant's motion was held before the Honorable William P. Copple, Judge of the United States District Court for the District of Arizona, and following the hearing of argument and the examination of the briefs of counsel, Judge Copple entered an order

denying Appellant's motion to vacate the judgment of dismissal. (A.R. 82) Although Mr. McKinney did not attend the hearing, he was ably represented there by Attorney James L. Corbett, Esquire, of Phoenix, Arizona, who had been retained by Mr. McKinney to represent him in the matter. (R.T. 2)

Thereafter, Appellant discharged Mr. Corbett (A.R. 88), and filed notice of appeal in propria persona. (A.R. 89)

ISSUE PRESENTED

Did the court below err in denying Appellant's motion to vacate judgment of dismissal with prejudice where the motion, based upon grounds of alleged "fraud," was not filed by Appellant until four and a half years after entry of the judgment of dismissal?

ARGUMENT

Appellant's pleadings and brief herein are replete with vicious, irresponsible and totally unfounded accusations of fraud and chicanery.

In order that the court may not draw any adverse inference from their silence, Appellees Boyle and their counsel categorically, emphatically and unequivocally deny Mr. McKinney's malicious accusations. Nothing more in this

regard need or will be said in the remainder of this brief.

As stated before, the final order of dismissal with prejudice in this case was entered on December 4, 1962. Rule 60 (b), Federal Rules of Civil Procedure, states:

> "On motion and upon such terms as are just, the Court may relieve a party or his legal representative from a final judgment, order, or proceeding for the following reasons: . . . 3. . . . The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) (fraud) not more than one year after the judgment, order or proceeding was entered or taken." (emphasis added)

Appellant purports to complain of the entry of a final order of dismissal with prejudice over four and one-half years after the order was entered. Appellant's motion was patently not timely made, and the court below was without jurisdiction to entertain it.

The rule is explained as follows:

> "But the concept of reasonable time cannot be used to extend a one year limit. A motion under clauses (1), (2) or (3) must be denied as untimely if made more than one year after judgment, regardless of whether the delay was reasonable." 3 Barron and Holtzoff, Federal Practice and Procedure, 421-2, §1330.

In the case of Kathe v. United States, 284 F. 2d 713 (9 Cir. 1960), this Honorable Court held that where a motion to vacate a judgment or final order was filed more than three years and eight months after the entry of the judgment, the District Court was without jurisdiction to entertain the motion. To the same effect, see Mitchell v. Board of Governors,

etc., 145 F. 2d 827 (9 Cir. 1944) cert. den. 324 U S. 845, 68 S. Ct. 677, 89 L. Ed. 1407.

Appellees Boyle respectfully submit that the order of the court below denying Appellant's motion to vacate the judgment was completely correct, and that the appeal herein should be dismissed and the decision of the court below affirmed.

Respectfully submitted

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By ______________________

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AFFIDAVIT OF MAILING

STATE OF ARIZONA)
) ss
COUNTY OF MARICOPA)

LEROY W. HOFMANN, being first duly sworn, upon his oath deposes and says: That he, on the 8th day of March, 1968, deposited in the United States Mail, at Phoenix, Arizona, with postage prepaid thereon, two (2) copies of the foregoing Appellees' Brief, addressed to

Mervin Carlos McKinney, prose.
P. O. Box B - 1030
Tamal, California

LEROY W. HOFMANN

Subscribed and sworn to before me, this 8th day of March, 1968.

/s/ Sylvia Cobb
Notary Public

My Commission expires:

2/3/72

C E R T I F I C A T E

I, LEROY V. HOFMANN, certify that in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and, in my opinion, the foregoing Brief is in full compliance with those Rules.

KENNETH S. SCOVILLE

By ______________________________
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Nos. 22277, 22277A and 22277B

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 22277

ESTATE OF BERNARD H. STAUFFER, BONNIE H. STAUFFER, EXECUTRIX,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 22277A

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ESTATE OF BERNARD H. STAUFFER, BONNIE H. STAUFFER, EXECUTRIX,

Petitioner,

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COMMISSIONER OF INTERNAL REVENUE,

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On Petitions for Review of the Decisions of the Tax Court of the United States.

PETITIONER'S OPENING BRIEF.

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OPINION BELOW.

These are consolidated appeals from decisions of the Tax Court of the United States (Raum, J.) before

which Court the proceedings were consolidated. The findings of fact and opinion of the Tax Court of the United States are reproduced at pages 180-242 of the Record and are reported at 48 T.C. 277.

JURISDICTION.

Each appeal involves liability for income taxes imposed under Chapter 1, Subtitle A, of the Internal Revenue Code of 1954, for fiscal years ended January 31, 1958, January 31, 1959, and the eight month period ended September 30, 1959 in the case of Stauffer Reducing, Inc. of California, and for the eight month period ended September 30, 1959 in the case of Stauffer Reducing, Inc. (Illinois) and Stauffer Reducing, Inc. of New York. The petition for review was filed September 5, 1967 in each case [Record, pp. 252-261], pursuant to Section 7482 of the Internal Revenue Code.

SUMMARY STATEMENT OF THE CASE.

These cases involve the ultimate issue of whether a disastrous operating loss of Petitioner's business may be carried back against earlier profits of that same business under identical ownership. Although such carryback right is normally available under such circumstances, the Tax Court opinion holds that in the instant cases the carryback was completely forfeited because of the particular manner in which the states of incorporation of that business were moved to New Mexico.

The material facts contained in the Tax Court's findings of fact [Record, pp. 182-213] are not disputed by Petitioner. Substantially all of the facts were stipulated by the parties, and said stipulated facts, together with accompanying exhibits, are incorporated by reference in the findings of fact [Record, p. 182].

The basic facts and issues in the cases here at bar are as follows:

FACTS.

Prior to September 30, 1959, Bernard H. Stauffer was the sole stockholder of three corporations, each of which was engaged in the same business—the manufacture and sale of weight reducing apparatus [Record, pp. 185-6].

By far the largest of these corporations was Stauffer Reducing, Inc. of California, a California corporation ("Stauffer California"). It sold units in the Western United States, and, until 1958, did all of the manufacturing for the entire business operation. The second largest was Stauffer Reducing, Inc., an Illinois corporation ("Stauffer Illinois"), which sold the Stauffer products in the Mid-West, and, from 1958 on, did some of the manufacturing for the business. The third, and by far the smallest of the companies, was Stauffer Reducing, Inc. of New York, a New York corporation ("Stauffer New York"), which handled sales for the Northeastern United States [Record, pp. 185, 194, 196; Exs. 16-J, 19-M, 22-P].

In 1959, for bona fide business reasons, Stauffer California purchased land in Albuquerque, New Mexico, for the purpose of relocating the business in Albuquerque. It was also decided to relocate the operations of the Illinois and New York corporations in Albuquerque, and to combine the entire business operations into a single New Mexico corporation. All of the negotiations for the relocation of the business were conducted by Stauffer California, all of the Board of Directors' discussions (except for formal adoption of the merger)

relating the move were conducted by Stauffer California, and that corporation actually acquired the site to which the main office of the business was to be moved [Record, pp 188, 191].

To accomplish the relocations, Stauffer Laboratories, Inc., a New Mexico corporation ("Stauffer New Mexico"), was formed in August of 1959. On October 1, 1959 the three old companies reincorporated in New Mexico by means of a statutory merger with Stauffer New Mexico [Record, pp. 188-9].

There was no change in the business, method of operation, officers, directors or shareholders of the companies as a result of the reincorporation. Indeed, due to the business reverses described below, the plan to relocate the Stauffer business in New Mexico was never implemented, and the business continued to operate after the reincorporation precisely as before [Record, p. 191].

Pending a determination as to whether closing returns were required of the merged companies, requests for extensions of time were filed and estimated tax payments totaling $507,500 were made on December 15, 1959. No closing returns were in fact filed, pursuant to a determination that the reincorporation constituted an "F" reorganization. A return was filed by Stauffer New Mexico at the close of its fiscal year ending January 31, 1960, which return included the income of the three merged companies through September 30, 1959, totaling about $1,500,000, and a loss of about $800,000 suffered by Stauffer New Mexico during the remaining four months of the fiscal year, resulting in taxable income for the entire year of about $700,000. This return was accepted by the Internal

Revenue Service substantially as filed, and a minor overassessment was refunded [Record, pp. 192-4].

The business continued to suffer catastrophic losses, and Stauffer New Mexico was liquidated at the end of the next fiscal year, January 31, 1961. Its final return showed a loss of $3,366,052. Pursuant to its claim that an "F" reorganization had occurred in 1959, Stauffer New Mexico filed a carryback claim, contending that it was entitled to carry back its losses against premerger income. This claim was filed under the so-called "quickie" refund procedure of Section 6411 of the Internal Revenue Code of 1954 (the "Code"), which directs the Government to make a refund within ninety days after the claim was filed, subject only to a limited review of the claim. The claim was allowed, and the amount of the carryback claim was refunded to Stauffer New Mexico. Subsequently, upon audit, the Government took the position that the reorganization was not an "F" reorganization, and therefore the carryback was improper. In addition, the earlier approval of the 1960 return was reversed, and deficiencies asserted on the ground that closing returns should have been filed by all of the companies at September 30, 1959 [Record, pp. 195-6, 198-9].

The notices of deficiency were issued to Bernard H. Stauffer, determining his liability as the ultimate transferee of the assets of Stauffer California, Stauffer Illinois, and Stauffer New York. Mr. Stauffer died after the issuance of said notices, and the petitions before the Tax Court were filed by his estate [Record, p. 183].

LEGAL QUESTIONS.

1. The "F" Reorganization Issue.

The two legal questions presented upon this appeal which relate to the "F" reorganization issue are: (a) whether the taxable year of each of the old companies was required to end at the time of the merger, with the consequence that each was obligated to file a closing return for the period February 1 through September 30, 1959, and (b) whether the net operating losses sustained by Stauffer New Mexico for its fiscal year ending January 31, 1961 could be carried back and applied against the premerger income of the old companies.

Under Section 381(b) of the Code, the carryback of the operating losses incurred by the successor corporation, Stauffer New Mexico is permitted against premerger income, provided the transaction qualified as an "F" reorganization.[1] An "F" reorganization is defined under Section 368(a)(1)(F) as "a mere change in identity, form, or place of organization, however effected."

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[1]Section 381(b) of the Code provides, in part, as follows:

"(b) Operating Rules. — Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

* * *

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation."

Section 172(b) provides, in part, as follows:

"(b) Years To Which Loss May Be Carried.—

(A)(i) . . . a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss."

It is undisputed that an "F" reorganization may (and ordinarily does) also qualify under one of the other reorganization definitions.[2] Also, there is no dispute as to Petitioner's handling of its tax returns if the reincorporation here involved was an "F" reorganization. Further, it is not believed to be disputed that the reincorporation of each of the old companies, effected separately, would have constituted an "F' reorganization, and the carryback would have therefore been available. The legal question here involved is whether the combining of the three corporate entities at the same time that the reincorporation takes place operates to disqualify all transactions from the "F' reorganization provisions, with the result that the carryback right is forfeited. Thus, the issue is whether the facts here qualify as an "F" reorganization of any or all of the predecessor corporations.

2. The "Erroneous Assessment" Issue.

The remaining legal question presented upon this appeal relates to the so-called "erroneous assessment" issue. It stems from the fact that $1,695,125.30 of the amount claimed in this proceeding as constituting a deficiency of Stauffer California actually represents moneys refunded to Stauffer New Mexico in connection with the carryback claim filed by Stauffer New Mexico long after the merger. Stauffer New Mexico is not a party to this proceeding, and Petitioner has not in this proceeding been assessed as the transferee of a primary tax obligation of Stauffer New Mexico. Petitioner's contention is that under the Tax Court's holding Stauffer New Mexico must be regarded as an en-

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[2]Rev. Rul. 57-276, 1957-1 C.B. 126; Rev. Rul. 58-422, 1958-2 C.B. 145; Regs. § 1.381(b)-1(a)(2) (T.D. 6480 7/12/60).

tirely different taxpayer than Stauffer California, and that the refund was therefore paid to a corporate stranger to this proceeding. The legal question, therefore, is whether the refund paid to Stauffer New Mexico can properly be included as an element of the deficiency of Stauffer California for the fiscal years ending January 31, 1958 and 1959, respectively.

SPECIFICATION OF ERRORS.

The Tax Court of the United States erred:

1. In failing and refusing to hold and decide that the mergers of Stauffer California, Stauffer Illinois and Stauffer New York into Stauffer New Mexico constituted an "F" reorganization within the meaning of Section 368(a)(1)(F) of the Code, and that: (i) pursuant to Section 381(b)(1) of the Code, the taxable years of Stauffer California, Stauffer Illinois, and Stauffer New York did not end on October 1, 1959, the date of their merger into Stauffer New Mexico, and (ii) Stauffer New Mexico was entitled to carry back its operating loss of $3,366,052 for the fiscal year ended January 31, 1961 against the premerger income of Stauffer California, Stauffer Illinois, and Stauffer New York pursuant to Sections 381(b)(3) and 172 of the Code.

2. In the alternative, in failing and refusing to hold and decide that the merger of Stauffer California into Stauffer New Mexico was an "F" reorganization within the meaning of Section 368(a)(1)(F) of the Code, that said "F" reorganization occurred simultaneously with two "A" reorganizations involving Stauffer Illinois and Stauffer New Mexico, within the meaning of Section 368(a)(1)(A) of the Code, and that: (i) pursuant to Section 381(b)(1) of the Code,

the taxable year of Stauffer California did not end on October 1, 1959, the date of its merger into Stauffer New Mexico, and (ii) Stauffer New Mexico was entitled to carry back its operating loss of $3,366,052 for the fiscal year ended January 31, 1961 against the premerger income of Stauffer California pursuant to Sections 381(b)(3) and 172 of the Code.

3. In the alternative, in failing and refusing to hold and decide that the mergers of Stauffer California, Stauffer Illinois and Stauffer New York, respectively, into Stauffer New Mexico, constituted, in each case, an "F" reorganization within the meaning of Section 368(a)(1)(F) of the Code, and that: (i) pursuant to Section 381(b)(1) of the Code, the taxable years of Stauffer California, Stauffer Illinois, and Stauffer New York did not end on October 1, 1959, the date of their merger into Stauffer New Mexico and (ii) Stauffer New Mexico was entitled to carry back its operating loss of $3,366,052 for the fiscal year ended January 31, 1961 against the premerger income of Stauffer California, Stauffer Illinois and Stauffer New York pursuant to Sections 381(b)(3) and 172 of the Code.

4. In failing and refusing to hold and decide that the sum of $1,695,125.30 refunded to Stauffer New Mexico was not properly an element of the deficiency, determined under Section 6211 of the Code, of Stauffer California for the fiscal years ended January 31, 1958 and 1959.

5. In that its Opinion and Decisions are contrary to law.

6. In that its Opinion and Decisions are not supported by, but are contrary to, the findings of fact and the facts as stipulated by the parties.

SUMMARY OF ARGUMENT.

THE "F" REORGANIZATION ISSUE.

I.

Preliminary Statement.

A. The facts in this proceeding do not in any way involve tax avoidance motives or objectives.

B. The loss carryback contended for by Petitioner herein would have been undeniably available to Petitioner if the three merger transactions had not been accomplished at or about the same time. Thus, the factual situation herein is distinguishable from the factual situation in *Libson Shops v. Koehler* (1957), 353 U.S. 382, since in *Libson Shops* the loss carryovers would not have been available in the absence of the legal maneuvering.

C. The facts in this proceeding require a holding either that (1) the entire transaction was an "F" reorganization, (2) there was an "F" reorganization between Stauffer California, the dominant predecessor company, and Stauffer New Mexico, the successor company, or (3) each of the three mergers here involved constituted a separate "F" reorganization.

II.

The Tax Court's Decision Disregards the Intent of Congress in Enacting the Loss Carryback Provisions, and Completely Misconstrues the United States Supreme Court Holding in Libson Shops.

The Tax Court completely misconstrues the import of *Libson Shops.* The whole thrust of the Supreme Court's decision in *Libson Shops* was to reject the legal niceties of the corporate entities as controlling the availability of the loss, and instead, look to the purpose of

the carryover provisions. In *Libson Shops,* the taxpayer was attempting through legal maneuvering to secure the benefit of losses which would otherwise have not been available under the law. Exactly the reverse is true here. It is the Government who is denying a loss to the taxpayer which would have been undeniably available if the transaction had taken place in any other way.

III.

The Tax Court Has Not Only Repudiated All Authority Which Preceded Its Decision in the Cases at Bar, but Has Not Even Consistently Applied the Same Principles in Other Decisions Which It Has Handed Down in Recent Months.

A. In its most recent decision, *Casco Products Corp.* (1967), 49 T.C. No. 5, the Tax Court held, contrary to its holding herein, that since the loss carryback would have been available had the transaction been consummated in another manner, the Court would ignore the corporate formalities and permit the loss carryback.

B. In still another recent decision of the Tax Court, *Dunlap & Associates, Inc.* (1967), 47 T.C. 542, the Court, contrary to its holding herein, recognized the independence of three separate reorganizations occurring at or about the same time, and treated each reorganization as a separate reorganization for tax purposes.

IV.

The Authorities Are Unanimous That the Touchstone of an "F" Reorganization Is Continuity of Ownership and Business. In the Cases Here at Bar There Was Absolute Identity of Ownership and Business.

A. It is clear that all authorities preceding the decision here at bar have consistently regarded the dis-

tinguishing criteria of the "F" reorganization to be continuity of ownership and continuity of business activity.

B. In the cases at bar, there is no question but that all attributes of the Stauffer business remained the same before and after the reorganization, and that the reorganization was a mere change in identity, form, or place of organization, with no change in substance.

V.

Until the Cases at Bar, Respondent Uniformly Advocated the Position That the "F" Reorganization Provisions Should Be Interpreted Even More Broadly Than the Interpretation Contended for by Petitioner Herein.

A. Prior to the 1954 Code, the "F" reorganization provisions languished almost unnoticed because the other reorganization provisions were adequate to encompass virtually all reorganization transactions.

B. After the enactment of the 1954 Code the "F" reorganization provisions achieved new prominence, primarily because of the vigorous efforts of the Government in the so-called "liquidation-reincorporation" area to construe the "F" reorganization as broadly as possible as a "catch all" reorganization to cover a broad array of alleged "liquidation-reincorporation" situations.

C. The Government has advocated a broad interpretation of the "F" reorganization provisions in both its published rulings and in a number of litigated cases, and has urged a far broader construction of the "F" reorganization provisions than is contended for by Petitioner herein.

VI.

The Tax Court's Decision Erroneously Repudiated Its Own Holding in Pridemark, Inc., and Erroneously Rejected the Holding of the Fifth Circuit in Davant v. Commissioner.

A. In *Pridemark, Inc.* (1964), 42 T.C. 510, modified on other grounds (4th Cir. 1965), 345 F. 2d 35, involving facts indistinguishable from those involved here, the Tax Court properly held that the transaction constituted an "F" reorganization. That decision has been cited by the Tax Court with approval in a number of subsequent cases.

B. In *Davant v. Commissioner* (*sub. nom. South Texas Rice Warehouse Co.* (1965), 43 T.C. 540; aff'd. in part and rev'd. in part (5th Cir. 1966), 366 F. 2d 874, cert. den. 386 U.S. 1022), involving facts indistinguishable from those involved here, the Fifth Circuit properly held that the transaction constituted an "F" reorganization.

C. The Tax Court erroneously repudiated its decision in *Pridemark*, and erroneously rejected the Fifth Circuit decision in *Davant*.

VII.

The Contentions of the Respondent and the Holding of the Tax Court Are Diametrically Contrary to the Previous Ruling Policy of the Respondent, Which Ruling Policy Respondent Still Purports to Abide by and Reaffirm.

A. In Rev. Rul. 58-422, 1958-2 C.B. 145, involving facts indistinguishable from those involved here, excepting only that a parent and two subsidiaries were involved rather than three brother-sister corporations, the

Service ruled that a transaction, identical to that effected here, constituted an "F" reorganization as to the parent corporation there involved.

B. Although the Tax Court purports to distinguish Rev. Rul. 58-422, *supra,* on the grounds that a parent and two subsidiaries were there involved, it is clear that the same principles of law are applicable in the case of brother-sister corporations as are applicable in the case of parent-subsidiary corporations.

C. In attempting to distinguish Rev. Rul. 58-422, the Tax Court evidences a complete misapprehension of the *Libson Shops* decision and Rev. Rul. 59-359, 1959-2 C.B. 475, in which the Government laid out rules it would follow in implementing the *Libson Shops* decision.

VIII.

The Tax Court Erred in Refusing to Hold, in the Alternative, That (a) the Merger Between Stauffer California and Stauffer New Mexico Constituted an "F" Reorganization, or (b) Each of the Three Mergers Constituted an Independent "F" Reorganization.

A. The holdings of the Tax Court in *Pridemark, supra,* and the Fifth Circuit in *Davant, supra,* are correct and should be followed in the cases here at bar.

B. In the alternative, however, the rationale of Rev. Rul. 58-422 requires that the facts in this proceeding be deemed to be an "F" reorganization of Stauffer California into Stauffer New Mexico, accompanied by two "A" reorganizations (under Section 368(a)(1)-(A) of the Code) between Stauffer Illinois and Stauffer New York, respectively, and Stauffer New Mexico.

C. In the further alternative, the facts in this proceeding should properly be regarded as three separate "F" reorganizations.

D. Rev. Rul. 58-422 also involved a single merger agreement effecting three mergers, and there is no more reason to fragment the transactions in Rev. Rul. 58-422 than there is to fragment them in the cases here at bar.

E. Had the Government been asked to rule in the cases here at bar that the transaction amounted to an "F" reorganization as to Stauffer California, it is believed that the Government would have unquestionably so ruled upon the strength of Rev. Rul. 58-422.

F. The tax aspects of the transaction should not depend upon whether or not the taxpayer announced to the Service beforehand that the transaction was intended as an "F" reorganization.

G. Under the rationale of Rev. Rul. 58-422, it is unquestionable that Stauffer California, because of the fact that it had by far the most premerger profits, and was otherwise the dominant company, should be deemed to have participated in an "F" reorganization. Moreover, although the Tax Court refused to so hold, Stauffer California was the first of the companies to merge into Stauffer New Mexico.

H. The Tax Court holding in *Pridemark* and the Fifth Circuit holding in *Davant* properly interpret the law. Rev. Rul. 58-422 was adopted prior to the time that the Government fully thought through the "F" reorganization provisions in connection with its contentions in the "liquidation-reincorporation" area, and Rev. Rul. 58-422 is an unduly narrow construction of the law.

I. A narrower but alternative analysis is to regard the transactions as three separate "F" reorganizations, but even if this alternative were adopted. Petitioner has sufficiently traced postmerger losses and premerger income so as to be entitled to prevail herein.

J. In summary, Petitioner is entitled to prevail under any of the aforementioned alternative theories, and it is not actually necessary for this Court to choose between them in this proceeding.

K. The proper construction of the law cannot be found in meaningless semantical debate, but must be found by analyzing the purposes of the loss carryover and carryback provisions. Petitioner is the classic example of the reason for the loss carryback and carryover provisions and is manifestly entitled to prevail herein.

THE "ERRONEOUS ASSESSMENT" ISSUE.

I.

The Tax Court Erred in Permitting the "Erroneous Refund" Paid to Stauffer New Mexico to Be Included as an Element of the Deficiency of Stauffer California. Such Refund, Having Been Claimed by and Paid to Stauffer New Mexico, Must Be Recovered From Stauffer New Mexico.

The Tax Court improperly held that the $1,695,125.30 refund claimed by and paid to Stauffer New Mexico constituted a portion of the deficiency of Stauffer California. This amount was never claimed by or refunded to Stauffer California, but rather was claimed by and refunded to Stauffer New Mexico. The Government must proceed against Stauffer New Mexico to recover this sum, which it has not done in this proceeding.

ARGUMENT.

THE "F" REORGANIZATION ISSUE.

I.

Preliminary Statement.

Before embarking upon the technical discussion of the "F" reorganization issue, we believe it will be helpful to the Court to set the issue in its proper perspective.

As this Court is no doubt well aware, the problem of trafficking in loss corporations has had a long and colorful history in the courts, and, at first blush, there may be a tendency by this Court to identify the issue involved in the cases here at bar with those situations. However, it will be readily apparent to this Court as soon as it has an opportunity to acquaint itself with this case that no such trafficking in loss corporations is even remotely involved in this proceeding.

Also, there may be some first-blush tendency by this Court, as the Tax Court has apparently done even after studying the issues, to identify the cases here at bar with other cases in which legal maneuvering was utilized in order to attempt to make losses available against profits which, in the absence of such legal maneuvering, would not have been available to offset said profits. The landmark decision in this regard is *Libson Shops, Inc. v. Koehler* (1957), 353 U.S. 382, which, as this Court will recall, involved an attempt by a taxpayer who owned some seventeen brother-sister corporations, some of which operated at a profit, and some of which operated at a loss, to combine the corporations via a statutory merger and thereby be in a

position to use the loss carryover from the loss corporations against the profits from the profit corporations.

The cases here at bar have none of these attributes. The loss carryback which is involved in these cases would have been undeniably available against the profits of Stauffer California, for example, under any of the following factual hypotheses:

1. A carryback would have been undeniably available had Stauffer New York and Stauffer Illinois merely merged into Stauffer California.[3]

2. The carryback would have been undeniably available had Stauffer California merely moved its place of incorporation from California to New Mexico.[3]

3. The carryback would have been undeniably available had Stauffer New York and Stauffer Illinois first been merged into Stauffer California, and then Stauffer California had moved its state of incorporation from California to New Mexico.[3]

4. The carryback would have been undeniably available had Stauffer California moved its state of incorporation to New Mexico, and thereafter Stauffer New York and Stauffer Illinois had merged into Stauffer California.[3]

Under the holding of the Tax Court this carryback, which would have been undeniably available under any of the above factual patterns, is forfeited merely because of the happenstance that the change in place of incorporation and merger were consummated at or about the same time.

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[3]The reasoning supporting this statement will be explained *infra* in this brief. See Footnote 21 and the text relating thereto.

Figuratively speaking, we submit that the taxpayer has been victimized by the old shell game. We submit that the pea, *i.e.,* the loss carryback, must be found under one shell or another, but the Government and the Tax Court, through conceptual legerdemain, have secreted it up their sleeve!

In short, Petitioner's contention is that the cases here at bar necessarily fit within one of the following alternative analyses:

1. Based upon prior court decisions, the facts should be viewed as one "F" reorganization in which all of the companies involved are parties to the reorganization.

2. In the alternative, based upon the published ruling position of the Service, the facts should be viewed as an "F" reorganization of the dominant predecessor company, Stauffer California, occurring in conjunction with two separate statutory mergers involving the other two predecessor companies.

3. In the alternative, assuming that a narrower rule were to be established than alternatives 1 or 2 above, the facts should be viewed as an "F" reorganization of each of the predecessor companies.

Although Petitioner believes that the first of the above mentioned alternatives is the proper view, it is not necessary in this proceeding for this Court to determine which of the three alternatives should be adopted, since, as will hereinafter be demonstrated. Petitioner is entitled to prevail herein under any of the above alternative theories.

II.

The Tax Court's Decision Disregards the Intent of Congress in Enacting the Loss Carryback Provisions, and Completely Misconstrues the United States Supreme Court Holding in Libson Shops.

In the light of the preliminary statement, the first logical area of inquiry is to determine what could have motivated the Tax Court to reach its conclusion that the loss is forfeited as a result of the combination of the three otherwise permissible transactions. The answer to this becomes evident from the portions of the Tax Court's opinion [Record, pp. 228-9], in which the Court envisions "unintended difficulties" in the administration of the law, and concludes [Record, p. 230] that in order to avoid such "unintended difficulties" the loss should be denied.

Perhaps the most distressing aspect of the Tax Court's decision is that, apart from a brief passage in which the Court misinterprets the *Libson Shops* holding [Record, pp. 226-7], the Court does not address itself to the purposes and intent of the loss carryback provisions. Instead, the Court's opinion relies upon a variety of frail legal and factual distinctions[4] to sup-

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[4]On page 44 of its opinion [Record, p. 223] the Court set forth a series of what it regarded as "significant" formalistic changes. We submit, however, that whether or not such formalistic changes could be regarded as having significance in some non-tax context of the law, they have no significance, and indeed are irrelevant, to a determination of the taxing law here involved. We submit that from a tax standpoint, what is significant is found in the following findings of the Court:

> ". . . Stauffer New Mexico's principal place of business was 1919 Vineburn Avenue, Los Angeles, California, which had previously served as the main office of Stauffer California and from which the affairs of all Stauffer enterprises had been guided and controlled. It continued to carry on the operations previously conducted by the old Stauffer

port its conclusion. It seems incongruous that an entire life's work of the decedent taxpayer is to be emasculated and his widow and children essentially bankrupted, all upon the basis of such frail distinctions, without any analysis of the purposes and intendment of the loss carryback provisions.

It is apparent from the Court's limited discussion of the *Libson Shops* decision that it completely miscon-

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companies from the same locations and in the same manner as before the merger. The accounting record continued to be broken down as though the three old Stauffer companies were still in existence, except that no inter-company profits appeared on the books" [Record, p. 191].

On page 45 of its opinion [Record, p. 224] the Court professed to perceive some significance in the singular use of the word "corporation" in Section 202(c)(2) of the Revenue Act of 1921. We submit that such an exercise by the Court is a fruitless semantical excursion, since *all reorganization definitions are framed in the singular*, and thus the use of the singular yields no insight whatever into what is meant by the statutory test of a change in the identity or form of that corporation.

Moreover, if this grammatical debate were to be extended, we wish to respectfully point out to this Court that, read in full text, Section 202(c)(2) of the Revenue Act of 1921 is actually more favorable to Petitioner's contentions than it is to Respondent's. The full text is as follows:

> "When in the *reorganization of one or more corporations* a person receives in place of any stock or securities owned by him, stock or securities in *a corporation* a party to or resulting from such reorganization. *The word 'reorganization,' as used in this paragraph, includes* a merger or consolidation (including the acquisition by *one corporation* of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of *another corporation*, or of substantially all the properties of *another corporation*), recapitalization, or mere change in identity, form, or place of organization of *a corporation*, (however effected);" [Emphasis added].

As to the *Berghash* case cited by the Court at page 45 of its opinion [Record, p. 224], the use of the singular by the Court is equally unenlightening. The *Berghash* case only involved one corporation, and therefore the Court would have no occasion to concentrate on the plural expression. Indeed, from other passages which are quoted in Section VI of this brief, it is apparent that the *Berghash* case is favorable to Petitioner herein.

strued the import of that decision, and this, in turn, adversely affected its attitude toward the established law relating to "F" reorganizations. The Court [Record, pp. 226-7] discusses the *Libson Shops* decision as supporting its conclusion that Stauffer New Mexico cannot be regarded as the same taxpayer as its predecessors. In fact, however, the rationale of the *Libson Shops* decision is directly to the contrary. The very first thing that the Supreme Court did in the *Libson Shops* case was to reject the legal niceties of the corporate entities as controlling the availability of the loss. Instead, the Court looked to the basic purpose of the carryover provisions and held that the corporate formalities were totally irrelevant to the question as to whether the same taxpayer was involved. Under the Supreme Court's decision in *Libson Shops,* even the same corporate entity may not be the same "taxpayer", and therefore may not be entitled to utilize the loss incurred by that very same corporate entity.[5]

What concerned the Court in *Libson Shops* was the fact that the taxpayer was attempting by means of the

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[5]"Equally misplaced is petitioner's emphasis on the fact that since, in the instant case, the surviving corporation was the loss corporation, whereas in *Libson Shops* the loss corporations were merged into the surviving corporation, the principle of *Libson Shops* is inapplicable. We have considered this argument in the past and concluded that merely because the loss corporation survives to claim the carryover, that fact will not present a bar to the application of the reasoning in *Libson Shops. Frank IX & Sons irginia Corp.* [Dec. 27,871], 45 T.C. 533, 542 (1966), aff'd. [67-1 USTC ¶9369] 375 F.2d 867 (C.A. 3, 1967), certiorari denied .... U.S. .... (Oct. 16, 1967); *Julius Garfinckel & Co.* [Dec. 26,262], 40 T.C. 870, 877 (1963), aff'd. [64-2 USTC ¶9626] 355 F. 2d 744 (C.A. 2, 1964), certiorari denied 379 U.S. 962 (1965.)"

Consolidated-Hammer Dry Plate & Film Co. (1967), 49 T.C. No. 18, p. ....; CCH T.C. Reg. Dec. p. 2942, at pp. 2951-2.

merger transaction to offset losses of loss corporations against profits of other profit corporations, a feat which would not have been possible under the law in the absence of the merger transaction.[6]

As has already been pointed out above, however, the taxpayer here is not trying to offset losses that would not otherwise have been allowable under the law in the absence of the mergers. *Exactly the reverse is true!* It is the Government, supported by the Tax Court, who would deny a loss to the taxpayer which would have been undeniably available to the taxpayer not only if the mergers had not taken place, but more importantly, even if the mergers had taken place in any other way.[7]

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[6]"Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to setoff its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year [footnote omitted]. There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of the premerger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What history there is suggests that Congress primarily was concerned with the fluctuating income of a single business [footnote omitted]. * * * *

"In the present case, the 16 sales corporations, prior to the merger, chose to file separate income tax returns rather than to pool their income and losses by filing a consolidated return. . . . If petitioner is permitted to take a carry-over, the 16 sales businesses have acquired by merger an opportunity that they elected to forego when they chose not to file a consolidated return. * * * *

"We find nothing in those provisions which suggest that they should be construed to give a 'windfall' to a taxpayer who happens to have merged with other corporations. The purpose of these provisions is not to give a merged taxpayer a tax advantage over others who have not merged." *Libson Shops v. Koehler* (1957), 353 U.S. 382 at 386-7, 390.

[7]Any exception to this statement would have to be premised upon a totally unreasonable hypothesis, *e.g.*, that taxpayer would have elected to merge the other corporations into tiny Stauffer New York.

The essence of the Tax Court's decision is that the simultaneous combination of corporate transactions, each of which individually would have resulted in the availability of the carryback, results in the complete destruction and forfeiture of the carryback.

The entire efforts of the courts and the Congress in recent years have been dedicated to the proposition that the availability of loss carrybacks and carryovers should not be determined by corporate artificialities, but rather by the economic realities of the transaction. This is the whole point of the *Libson Shops* decision and a host of decisions which have followed it.[8] But even before *Libson Shops,* Congress itself, when enacting the 1954 Code, was intent upon the task of casting the statutory language to accomplish this end. As stated in the Senate Finance Committee Report (S. Rep. No. 1622, 83d Cong. 2d Sess. p. 52):

> "Present practice rests on court-made law which is uncertain and frequently contradictory. Your Committee agrees that whether or not the items carryover should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization.
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[8]This Court has, of course, held that the *Libson Shops* decision is not applicable under the 1954 Code. *Maxwell Hardware Co. v. Commissioner* (9th Cir. 1965), 343 F.2d 713. However, the decision is not here being cited for the proposition that the precise issue involved in *Libson Shops* is applicable under the 1954 Code. What is here being asserted is that the fundamental rationale and philosophy of the case; namely, that the purpose of the loss carryover and carryback provisions should be implemented by the Courts irrespective of legal artificialities, is equally applicable under the 1954 Code. The Tax Court itself recognized the applicability of the *Libson Shops* rationale to the cases at bar, but it unfortunately misconstrued this rationale [Record, p. 227, fn. 7].

> "The new rules enable the successor corporation to step into the 'tax shoes' of its predecessor corporation without necessarily confirming to artificial legal requirements which now exist under court-made law."

Congress' action in 1954 in revamping the operating loss provisions in an effort to make economic realities rather than corporate formalities control the availability of the loss carrybacks predated and presaged the *Libson Shops* decision itself. In *Libson Shops,* the Supreme Court decided that the same legislative intent was equally applicable to the 1939 Code and undertook to apply it to overrule the "uncertain and frequently contradictory" court-made law under the 1939 Code. In so doing, the Supreme Court no doubt was aware of the practical difficulties which would ensue as a result of its decision, and the Court obviously felt that the inconvenience which might be caused in implementing the decision was immaterial to the proper interpretation of the statute.

III.

The Tax Court Has Not Only Repudiated All Authority Which Preceded Its Decision in the Cases at Bar, but Has Not Even Consistently Applied the Same Principles in Other Decisions Which It Has Handed Down in Recent Months.

Fifteen years of progress in interpreting the loss carryover and carryback provisions have been incomprehensibly ignored by the Tax Court in its decision. The Tax Court by its decision would have us revert once again to worshiping the tin god of corporate formalities, a doctrine which has universally been rejected since the advent of *Libson Shops* and the 1954 Code.

One of the strangest aspects of the Tax Court's decision is that it not only rejected or repudiated the authorities which preceded its decision,[9] but the Tax Court itself has not even consistently adhered to the fundamental rationale of its *Stauffer* decision in other decisions which it has rendered in recent months.[10]

The most recent decision of the Tax Court, *Casco Products Corp.* (1967), 49 T.C. No. 5, was filed October 24, 1967. There, P corporation owned 91% of the stock of S corporation, and in order to "freeze out" the 9% minority shareholders, P formed a new corporation, into which S was merged, thereby enabling S under local law to pay off the minority shareholders of S in cash. After the merger, the new corporation attempted to carry back losses of the new corporation against premerger profits of S. The Government thereupon took the position that the carryback was not allowable because the reorganization did not qualify as an "F" reorganization in view of the 9% shift in ownership. Even the Tax Court, however, recognized the inequity of denying the loss carryback. The Tax Court refused to be stampeded into an erroneous result by rigid adherence to the legal artificialities involved. Instead, it held that the new corporation was really a continuation of the old corporation, that the net effect of the transaction was a redemption of stock, and that corporate formalities would be ignored. It was as if a different court was talking than the one which de-

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[9]These past authorities will be discussed in ensuing sections of this brief.

[10]As this Court is no doubt aware, the Tax Court also handed down another decision in accordance with *Stauffer* a few days after the *Stauffer* decision, *Associated Machine* (1967), 48 T.C. 318, and that case is also presently pending on appeal before this Court.

cided the *Stauffer* decision here at bar just a few months earlier. In *Casco Products* the Court stated (CCH T.C. Reg. Dec. pp. 2870-71):

> "Thus, both parties invite us to engage in an interpretative exercise as to the scope of section 368(a)(1)(F) and the relationship between sections 381(b) and 172. We decline the invitation to attempt to navigate these treacherous shoals. See *Reef Corporation v. Commissioner* [66-2 USTC ¶9716], 368 F.2d 125 (C. A. 5, 1955), certiorari denied 386 U.S. 1018 affirming in part and reversing as to the 'F' reorganization issue a Memorandum Opinion of this Court [Dec. 27, 309(M)]; *Estate of Bernard H. Stauffer* [Dec. 28,497]; 48 T.C. 277 (1967), on appeal (C. A. 9, Sept. 5, 1967); *Associated Machine* [Dec. 28,501], 48 T.C. 318 (1967), on appeal (C. A. 9, Sept. 15, 1967); *Dunlap & Associates* [Dec. 28,354], 47 T.C. 542 (1967). Instead we take a different tack.
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> "*There is no question, and indeed, respondent so concedes, that if Old Casco had redeemed the shares of the minority shareholders and had continued in business the loss carryback would have clearly been available. As we see it, the circumstances herein should not produce a different result. To hold otherwise would be to exalt form over substance and to accord an unjustifiable vitality to the merger format which was admittedly adopted only as a 'legal technique.'* (Emphasis added).

* * *

> "Under these circumstances, the merger was a reorganization in form only and should consequently be ignored as such. What took place was a redemption of 9 percent of the Old Casco shares and no more. [footnote omitted]. Under the limited circumstances of this case, we hold that New Casco was simply a continuation of Old Casco and the loss carryback should have been allowed."

The holding of the Tax Court in the *Casco Products* case was eminently correct, but completely inconsistent with the rationale of the *Stauffer* decision here at bar, and this fact was obvious to Judge Raum (the author of the *Stauffer* decision), who dissented from the decision (along with four other Judges).

Still another recent decision of the Tax Court will further demonstrate the incongruity of the situation. *Dunlap & Associates, Inc.* (1967), 47 T.C. 542, was decided by the Tax Court on February 28, 1967, which date was several months before the *Stauffer* decision was rendered, but was well after the *Stauffer* cases had been taken under submission by the Court. In the *Dunlap* case, P, a New York corporation, owned a controlling interest, but less than 80%, in several other corporations. In connection with a proposed public offering of P stock, P was advised that in order to clear up the validity of certain previous corporate transactions it should create a new Delaware corporation and merge itself into the Delaware corporation, and that it should simultaneously acquire the minority interests in two of the corporations in which it owned a controlling in-

terest. On June 28, 1961, the new corporation made a tender offer to exchange its stock for the stock of the minority shareholders of the two corporations controlled by P, and its tender offer was accepted by all of the minority shareholders during the period June 29, 1961 through July 7, 1961. The merger of P into the new Delaware corporation was effected on June 30, 1961. The issue in the case was whether the merger transaction constituted an "F" reorganization. The Government took the position that the merger transaction was a reorganization separate and apart from the reorganizations involving the two controlled corporations, and that this merger transaction constituted not only an "A", but also an "F" reorganization. The taxpayer contended that the merger and the exchange of stock with the minority shareholders were all part and parcel of a single plan and should be viewed as a whole, and that, viewed as such, the transactions would not qualify as an "F" reorganization because of the change in proprietary interest due to the elimination of the minority shareholders. The Tax Court, which absolutely refused to consider such an approach in the *Stauffer* decision, had no difficulty whatsoever in the *Dunlap* case separating the one overall plan into its separate component parts, the Court stating as follows (pp. 550-551):

> "While it appears that the formation of the petitioner under the laws of Delaware, the merger of the New York corporation into it, and the acquisition by the petitioner of the stock of the sub-

> sidiaries were all contemplated from the beginning and were deemed necessary to a public stock offering, this does not estalish that all such actions were parts of a single transaction constituting one reorganization or one plan of reorganization.
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> * * * *
>
> "In our opinion it must be considered that the various acts accomplished involved more than one reorganization within the contemplation of the statute. The merger of the New York corporation into the petitioner constituted a separate reorganization under section 368(a)(1)(A) and (F), and the acquisitions of the minority interests in the subsidiaries constituted two separate reorganizations under section 368(a)(1)(B)."

The holding in the *Dunlap* case is a correct holding. The Court recognized the economic realities of the situation and refused to be led astray by the taxpayer's technical arguments. Fundamentally, the Court recognized that there is no reason why three independent reorganizations cannot occur at or about the same time, and whether such reorganizations should be treated from a tax standpoint as separate reorganizations or one reorganization should depend upon the economic realities of the situation and the purposes of the statutory language involved.

The *Dunlap* case cannot rationally be distinguished from the *Stauffer* decision; yet in the *Stauffer* decision the Tax Court was content to dismiss the case in a footnote as "distinguishable." [Record, p. 233, fn. 9].

IV.

The Authorities Are Unanimous That the Touchstone of an "F" Reorganization Is Continuity of Ownership and Business. In the Cases Here at Bar There Was Absolute Identity of Ownership and Business.

Although, for reasons to be more fully explored in the next section of this brief, there is a relative paucity of authorities interpreting the "F" reorganization provisions, it is clear that all authorities preceding the decision here at bar have consistently regarded the distinguishing criteria of the "F" reorganization to be continuity of ownership and continuity of business activity. In *Ahles Realty Corporation v. Commissioner* (2nd Cir. 1934), 71 F. 2d 150, an "F" reorganization was described, at page 151, thusly:

> "When this transaction was completed, it was found that the sole stockholder of the old, the sole stockholder of the new, had a 100 per cent control over and interest in the identical assets * * *
>
> "There was a continuity of interest in the transaction, a continuance of the business conducted by the old corporation under the modified corporate form. After reorganization, the sole stockholder became the sole stockholder of the new, and the new corporation at completion was possessed of the same assets as the old * * * [I]t was 'a mere change in identity, form, or place of organization, however effected.' "

The same rationale was applied in *George Whittell & Co.* (1936), 34 B.T.A. 1070, and in *Helvering v.*

Southwest Consolidated Corp. (1946), 315 U.S. 194, at pp. 202-3, where the Supreme Court stated:

> "And a transaction which shifts the ownership of the proprietary interest in a corporation is hardly a 'mere change in identity, form or place of organization' within the meaning of clause [F]."

The Tax Court has reaffirmed this principle in a number of recent decisions. *Pridemark, Inc.* (1964), 42 T.C. 510, modified on other grounds (4th Cir. 1965), 345 F. 2d 35; *Book Production Industries, Inc.* (1965), 24 T.C.M. 339; *Hyman H. Berghash* (1965), 43 T.C. 743, aff'd. (2d Cir. 1966), 361 F. 2d 257; *Reef Corporation* (1965), 24 T.C.M. 379, rev'd. (5th Cir. 1966), 368 F. 2d 125, cert. den. 386 U.S. 1018; *Turner Advertising of Kentucky, Inc.* (1966), 25 T.C.M. 532.

See also, *Newmarket Manufacturing Co. v. U.S.* (1st Cir. 1960), 233 F. 2d 492, 497; *F. C. Donovan, Inc. v. U.S.* (1st Cir. 1960), 261 F. 2d 470, 472.

The Internal Revenue Service has stated that an "F" reorganization occurs:

> ". . . in all cases where there is no change in the existing stockholders or change in the assets of the corporations involved."
>
> Rev. Rul. 58-422, 1958-2 C.B. 145, 146.

See also:

Rev. Rul. 63-203, 1963-2 C.B. 580.

In the cases at bar, there is no question but that all of the attributes of the Stauffer business remained iden-

tically the same before and after the reorganization [Record, p. 191]:

(i) Mr. Stauffer was the owner of all of the stock of the business before and after the reorganization [Stip. 1, 8];

(ii) the directors of the business were identical before and after the reorganization [Stip. 11];

(iii) The officers of the business were identical before and after the reorganization [Stip. 11, 16];

(iv) The nature and operation of the business were identical before and after the reorganization [Record, p. 191].

Indeed, it is difficult to conceive of a closer identity of business before and after the reorganization, since the move to New Mexico was never implemented and thus the business remained exactly as before [Record, p. 191].

In short, there was absolutely no change in the business. The reorganization was a mere change in identity, form, or place of organization, with no change in substance, coming directly within the definition of an "F" reorganization set forth in every authority which has considered the question, excepting only the Tax Court below.

V.

Until the Cases at Bar, Respondent Uniformly Advocated the Position That the "F" Reorganization Provisions Should Be Interpreted Even More Broadly That the Interpretation Contended for by Petitioner Herein.

Although the "F" reorganization provisions have been in the Internal Revenue Code since 1921, they have languished almost unnoticed until the advent of the

1954 Code, simply because the other reorganization provisions were adequate to encompass virtually all reorganization transactions. After the enactment of the 1954 Code, however, the "F" reorganization provisions have achieved new prominence, primarily because of the vigorous efforts of the Government to apply the "F" reorganization provisions in the so-called "liquidation-reincorporation" area.[11]

Because of the difficulties under the 1954 Code of otherwise handling the "liquidation-reincorporation" situation,[12] the Internal Revenue Service has for many

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[11]The "liquidation-reincorporation" problem can arise in various contexts, but the essence of the problem involves an attempt to transfer the basic operating assets of a corporation to a related corporation (which may or may not be a newly formed corporation), and to dissolve the transferor corporation and distribute its liquid assets to its shareholders at capital gain rates. Several basic mechanical routes can be followed to achieve this end. The transferor corporation can sell its assets to the transferee corporation and then liquidate, or alternatively, the transferor corporation can first liquidate, and then the assets can be transferred by its shareholders to the transferee corporation. The argument in the "liquidation-reincorporation" area revolves around the question of whether the liquid assets received by the shareholders of the transferor corporation are entitled to be received on a capital gains basis, or whether distribution represents, in essence, a disguised dividend distributed as part and parcel of a reorganization transaction.

[12]Prior to the 1954 Code, the primary method of attack in the "liquidation-reincorporation" area was under the "D" reorganization provisions (Section 112(g)(1) of the Internal Revenue Code of 1939). Basically, the definition of a "D" reorganization under the 1939 Code encompassed any transfer of some or all of the assets of a corporation which was 80% controlled by the transferor corporation or any one or more of the shareholders of the transferor corporation. Under the 1954 Code, however, in order to accommodate the so-called "spin-off" provisions of Section 355, the definition of a "D" reorganization (Section 368(a)(1)(D)) was substantially narrowed in several respects. First, a requirement was added that in order to qualify as a "D" reorganization, substantially all of the assets of the transferor corporation must be transferred (Section 354(b)(1)(A)). Secondly, a requirement was added that in order to qualify as a "D" reorganization, stock, securities, and

years vigorously espoused the position that the "F" reorganization provisions should be construed very broadly as a "catch-all" reorganization to cover a broad array of alleged "liquidation-reincorporation" situations. The Service's first published pronouncement of its broad interpretation of the "F" reorganization provisions was in Rev. Rul. 61-156, 1961-2 C.B. 62, in which the Service applied the "F" reorganization provisions to cover an alleged "reincorporation" of a business *even though there was a 55% change in stock ownership.* The factual situation in that ruling involved the sale of substantially all of the assets of the transferor corporation to a new corporation formed by the management of the selling corporation. The consideration for the sale of these assets consisted of 45% of the stock of the new corporation, plus cash and long-term notes. Immediately after the sale the remaining 55% of the stock of the new corporation was sold to the public. The selling corporation was then liquidated, and the shareholders of the selling corporation thereupon ended up owning 45% of the transferee corporation. The Service ruled this to be an "F" reorganization, stating as follows (at p. 64):

> "The newly formed 'purchasing' corporation was utilized to effect, in substance, a recapitalization and a change in identity, form, or place of organization of the 'selling' corporation and, at the same time, to withdraw accumulated earnings from the corporate enterprise for the benefit of the shareholders, while they nevertheless continued a substantial equity interest in the enterprise.
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other properties received by the transferor, as well as the other properties of the transferor, must be distributed in pursuance of the plan of reorganization (Section 354(b)(1)(B)).

> "In view of the foregoing, it is held that the transaction here described constitutes a reorganization within the meaning of sections 368(a)(1)(E) and (F) of the Code."

Since the issuance of Rev. Rul. 61-156, Respondent has aggressively pursued the principles therein stated in a number of litigated cases. Recent cases in which Respondent has so contended include *Joseph C. Gallagher* (1962), 39 T.C. 144; *Book Production Industries, Inc.* (1965), 24 T.C.M. 339; *Reef Corporation* (1965), 24 T.C.M. 379, aff'd. (5th Cir. 1966) 368 F. 2d 125, cert. den. 386 U.S. 1018; *Hyman H. Berghash* (1965), 43 T.C. 743, aff'd. (2d Cir. 1966) 361 F.2d 257; *Turner Advertising of Kentucky, Inc.* (1966), 25 T.C.M. 532.

In each of the above cases, Respondent argued for the broadest conceivable construction of the "F" reorganization provisions, contending that the "F" reorganization should even be extended to encompass substantial shifts in ownership. Although Respondent now professes to confess the error of his ways (but only as applied to the facts of this proceeding), one may legitimately wonder whether this confession of error may be motivated solely by the fact that it is to the Government's advantage to so confess error here. One may also wonder whether the Government will again reverse its field when it is convenient for the Government to do so.

VI.

The Tax Court's Decision Erroneously Repudiated Its Own Holding in Pridemark, Inc., and Erroneously Rejected the Holding of the Fifth Circuit in Davant v. Commissioner.

The Government's broad interpretation of the "F" reorganization provisions was adopted by the Tax Court in *Pridemark, Inc. supra.*[13] The *Pridemark* case involved facts which are indistinguishable from those involved here. There two (or possibly three) brother-sister corporations were liquidated and reincorporated into a single corporation which, the Tax Court found, continued to conduct the same business with no substantial change in ownership. The Tax Court held that the combination of these corporations constituted an "F" reorganization, concluding as follows:

> "That the net effect of the 1958 and 1959 transactions of Pridemark and Connecticut and their stockholders, was first to eliminate the unsatisfactory dealership relationship with Golden Key, and then to continue the business enterprise with a new manufacturing supplier under a modified corporate form through Pridemark Enterprises, with both continuity of ownership and continuity in the field of business activity;
>
> * * *

[13]On appeal to the Fourth Circuit, the factual conclusion of the Tax Court was reversed on the ground that "the new corporation cannot fairly be considered a continuation of the old business * * *" inasmuch as the old business had been transferred to an entirely unrelated company (345 F.2d 35, at p. 42).

"That the above-mentioned transactions clearly fall within both the letter and the intent of section 368(a)(1)(F) of the 1954 Code, in that they constituted a 'mere change in identity, form, or [in the case of Connecticut] place of organization, however effected.'"

The principles enunciated in the *Pridemark* case remained undisturbed until the decision of the Tax Court in the cases at bar. Indeed, the Tax Court has referred to the *Pridemark* decision with approval in a number of cases. For example, in *Book Production Industries, Inc.* (1965), 24 T.C.M. 339, at p. 352, the Court stated:

"In Pridemark, Inc., 42 T.C. 510, all of the 'essential operating assets' of the business of the old corporation (selling prefabricated houses) were carried over to the new corporation, which then continued this same business activity with a new manufacturing supplier. All of the stock of both the old and the new corporations was in the same hands. Under those facts we found 'both continuity of ownership and continuity in the field of business activity' and held that the transactions constituted a reorganization both within the letter and spirit of Section 368(a)(1)(F)."

Similarly, in *Hyman H. Berghash* (1965), *supra,* 43 T.C. 743, at pp. 753-754, the Court stated:

"The respondent places considerable reliance on our recent decision in *Pridemark, Inc.,* 42 T.C. 510, on appeal (C.A. 4, Sept. 23, 1964). There three corporations that were controlled by the same individual were engaged in the business of selling prefabricated houses. Two were liquidated and

distributions of cash and other property were made to its shareholders. Just prior to the liquidation a new corporation was formed, the stock of which was issued to the same individual who had previously controlled the predecessor corporation. Subsequently he contributed to the new corporation a portion of the cash which had been distributed to him in liquidation. He also contributed a lease on certain office premises, together with a trade name 'Pridemark' and a business slogan, to the new corporation. The successor corporation continued to operate the same business as its predecessors had conducted and in the same location under the same name.

"We there held that the transaction qualified as 'a "mere change in identity, form, or place of organization" '".

* * *

"In the instant case there occurred a drastic shift in the proprietary interest of the owner of the predecessor corporation. . . . The situation before us, therefore, is distinguishable from *Pridemark, Inc., supra,* on a crucial point. Despite the fact that all of the operating assets were carried over to the successor corporation, which continued exactly the same business, in the same location, as had been conducted by the predecessor, the radical shift in stock ownership which occurred precludes us from holding that the transaction amounted to no more than 'a mere change in identity, form, or place of organization' within the meaning of section 368(a)(1)(F)."

A more recent case in which the Government urged its broad interpretation of the "F" reorganization provisions upon the Tax Court was *Davant v. Commissioner* (*sub nom. South Texas Rice Warehouse Co.* (1965), 43 T.C. 540; aff'd. in part and rev'd. in part (5th Cir. 1966) 366 F. 2d 874, cert. den. 386 U.S. 1022). *Davant* involved two brother-sister corporations, "Warehouse" and "Water", each with identical shareholders, and each in a separate, active business. The assets of one of the corporations, Warehouse, were transferred (via an intermediary) to the other corporation, Water, without any change in ownership, and thus the two businesses and corporations were fused into a single corporation with no change in ownership. In the process, however, $900,000 was distributed to the shareholders, and the issue in the case was whether the transactions amounted to a reorganization, with the result that the $900,000 distributed to the shareholders would be a dividend.

The Government argued to the Tax Court that the effect of the transaction was both a "D" and an "F" reorganization. The Tax Court held that the transactions constituted a "D" reorganization, with the result that the Court did not find it necessary to address itself to the "F" reorganization argument. By the time the *Davant* case came up on appeal, the Government no doubt realized that the arguments which it had been making in *Davant* and in other cases were totally inconsistent with the more advantageous posture it was taking in the Stauffer situation. As a result, the Government quietly jettisoned its "F" reorganization argument on appeal. However, the Fifth Circuit observed that the Government had argued the applicability of the "F" reorganization provisions be-

fore the Tax Court and adopted the "F" reorganization argument of the Government as its primary basis of holding on appeal. The relevant portions of the Fifth Circuit opinion, which aptly summarize Petitioner's position herein, are succinct enough to be reproduced here in their entirety (at pp. 883-4):

> "Since this interchange of events cannot be viewed as a complete liquidation, we must now decide, for the purposes of the federal tax code, what it is. In the Tax Court the Government contended that this was a 368(a)(1)(D) or (F) reorganization.
>
> "A section 368(a)(1)(F) reorganization is defined as 'a mere change in identity, form, or place of organization, however effected.' Since the Tax Court held that this transaction was a (D) reorganization, it apparently believed that it was unnecessary to decide the (F) question. In the past, type (F) reorganizations have overlapped with type (A), (C) and (D) reorganizations. For this reason this provision has received almost no administrative or judicial attention. It is true that a substantial shift in the proprietary interest in a corporation accompanying a reorganization can hardly be characterized as a mere change in identity or form. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).
>
> *"The term 'mere change in identity [or] form' obviously refers to a situation which represents a mere change in* form *as opposed to a change in substance. Whatever the outer limits of section 368(a)(1)(F), it can clearly be applied where*

> *the corporate enterprise continues uninterrupted, except for a distribution of some liquid assets or cash. Under such circumstances, there is a change of corporate vehicles but not a change in substance.* If Water had no assets of its own prior to the transfer of Warehouse's operating assets to it, could we say that Water was any more than the alter ego of Warehouse? The answer is no. The fact that Water already had other assets that were vertically integrated with Warehouse's assets does not change the fact that Water was Warehouse's alter ego. Viewed in this way, it can make no practical difference whether the operating assets were held by Water or Warehouse, and a shift between them is a mere change in identity or form. At least where there is a complete identity of shareholders and their proprietary interests, as here, we hold that the type of transaction involved is a type (F) reorganization. (Single emphasis added.)

In its decision below, the Tax Court erroneously repudiated [Record, p. 231] its decision in *Pridemark,* and erroneously rejected [Record, p. 232] the Fifth Circuit decision in *Davant.*[14]

[14]Some insight into the Court's thinking can perhaps be divined from the following statement of the Court in distinguishing the *Davant* case [Record, p. 231]: "Like *Pridemark,* this case [*Davant*] arose in the liquidation-reincorporation field, where it was to the Government's advantage to urge that there had been a tax-free reorganization." In essence, the Court appears to condone the Government's attitude that statutory construction depends upon whether or not such construction is to the Government's advantage.

VII.

The Contentions of the Respondent and the Holding of the Tax Court Are Diametrically Contrary to the Previous Ruling Policy of the Respondent, Which Ruling Policy Respondent Still Purports to Abide by and Reaffirm.

Although the Government professes that acceptance of the taxpayer's position in the cases at bar would result in dire complications in the administration and construction of the Code, and although the Government has successfully convinced the Tax Court of this position, the rulings of the Internal Revenue Service completely refute this position. This is apparent from an examination of Rev. Rul. 58-422, 1958-2 C.B. 145. There, three corporations—a parent and two subsidiary corporations—were merged in a single statutory merger (just as was done in the cases at bar), into a single successor corporation which was newly formed for that purpose under the laws of a different state. The Service ruled that the reorganization of the parent corporation was an "F" reorganization, stating as follows (at p. 146):

> "Revenue Ruling 57-276 [relating to 'F' reorganizations] is applicable in all cases where there is no change in the existing stockholders or change in the assets of the corporations involved. *In the instant case, the fact that the subsidiaries of the former parent were liquidated at the same time that the said parent reincorporated in a different state did not constitute a change in the stockholders or assets of the merged corporation. The stockholders of the former parent had the same equity in the surviving corporation as they had in the*

three old corporations, inasmuch as all of the assets of the three transferor corporations were held by the surviving corporation. . . .

* * *

"In view of the foregoing, it is held that the transaction in the instant case insofar as it relates to the transfer of the assets and liabilities of the parent to the new corporation, constitutes a reorganization within the meaning of Section 368(a)-(1)(F) of the Code. . . ."[15] (Emphasis added).

Petitioner submits that Rev. Rul. 58-422 cannot be distinguished from the cases here at bar. The Tax Court, however, purports to distinguish Rev. Rul. 58-422 by stating [Record, p. 233] that:

". . . since the subsidiaries or their businesses were always under the same corporate umbrella of the parent, both before and after the reorganization, it is plain that the situation presented in the ruling is not the same as the one before us."

We respectfully submit that the purported distinction conjured up by the Tax Court is imaginary. There is no reason whatsoever to distinguish a combination of a parent and two subsidiaries from a combination of three brother-sister corporations. In both situations

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[15]This same position was reaffirmed by the Service's more recent ruling, Rev. Rul. 63-203, 1963-2 C.B. 580. There the facts were identical to those involved in Rev. Rul. 58-422 except that one of the subsidiaries was only 95% owned by the parent. The Service held (under a corresponding stamp tax provision) that the transaction did not constitute an "F" reorganization, relying exclusively on the effect of the minor change in ownership interest arising out of the issuance of shares in the new company to the former minority shareholders in a subsidiary. The ruling assumed that but for this shift of ownership, the combination of the three companies would have been an "F" reorganization.

there is a combination of three separate entities into one successor entity. Indeed, Petitioner would be hard pressed to even understand the attempted rationalization by the Tax Court were it not for further language of the Court in *Associated Machine* (1967), 48 T.C. 318 (appeal pending before this Court), which case involved the same issue as involved in the cases at bar. There the Court stated with respect to Rev. Rul. 58-422 (at pp. 329-30):

> "Petitioner also relies on three rulings of the respondent which, it is argued, authorize a carry-back of petitioner's loss to Machine Shop's taxable year 1959. Rev. Rul. 57-276, 1957-1 C.B. 126; Rev. Rul. 58-422, 1958-2, C.B. 145; and Rev. Rul. 66-284, I. R. B. 1966-39. However, petitioner has overlooked a number of basic distinctions. First of all, the rulings deal with parent-subsidiary situations while the petitioner here is the surviving corporation of a merger between brother-sister corporations. That this is a material difference from the point of view of loss carrybacks is clear from a careful reading of Rev. Rul. 59-395, 1959-2, C.B. 475. That is, a member of an affiliated group may file a consolidated return with its constituent corporations. If a consolidated return is filed, the carryback and carryover provisions of the law are available to the group. Regulations 1.1502-21(b) and 1.1502-79. However, since a direct chain of ownership between the corporations is required before they can file consolidated returns, brother-sister corporations, related only by a common owner, are not entitled to this privilege. The theory behind this distinction is that if a parent

> and subsidiary can file a consolidated return and benefit from the carryback provisions of section 381(b), there is little reason to deny the same parent and subsidiary the right to effectuate the same thing in another way—by merging one into the other or both into a newly formed corporation. Brother-sister corporations, on the other hand, cannot file consolidated returns and therefore are not covered by these rulings."

The foregoing statements by the Tax Court make it evident that the Court is under an unfortunate misapprehension as to the status of the law. The whole point of the *Libson Shops* decision is exactly contrary to the Tax Court's statement of the law. If the theory behind Rev. Rul. 58-422 is that inasmuch as a parent and subsidiary could file a consolidated return, they should be entitled to all of the benefits of filing a consolidated return even though they elected not to do so, then the Supreme Court's view of the law in *Libson Shops* is precisely to the contrary:

> "In the present case, the 16 sales corporations, prior to the merger, chose to file separate income tax returns rather than pool their income and losses by filing a consolidated return. . . . If petitioner is permitted to take a carry-over, the 16 sales businesses have acquired by merger an opportunity that they elected to forego when they chose not to file a consolidated return."[16]

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[16]While it is true that the Supreme Court was erroneous in its statement that the brother-sister corporations in the *Libson Shops* case could have filed consolidated returns, since such privilege is not available to brother-sister corporations, nonetheless the quoted language amply demonstrates what the decision of the Court would be had the consolidated return privilege been available.

The Tax Court further evidenced a total misapprehension as to the meaning and purpose of Rev. Rul. 59-395, 1952-2 C.B. 475. In Rev. Rul. 59-395 the Internal Revenue Service laid out rules it would follow in implementing the *Libson Shops* decision, which would govern the extent "to which any operating losses . . . may be carried back or carried over across the line of the corporate fusion after a statutory merger or consolidation. . . ." (1959-2 C.B. 475, at 476). After an introductory discussion of the *Libson Shops* decision, Rev. Rul. 59-395 proceeds as follows (at pp. 478-479):

> "While on the basis of the particular facts before it in the Libson case a carry-over of a net operating loss was there denied, it is the opinion of the Internal Revenue Service that, in view of the principles enunciated and the decisions cited by the Court in that case, a different result would be warranted under the 1939 Code where a carry-over across the line of a statutory merger would result in application of either the premerger losses or unused excess profits credits of an absorbed constituent corporation to offset income derived by the resultant corporation from the same business by which the loss was sustained or the credit acquired. *For the same reasons, carry-backs of net operating losses and unused excess profits credits of the resultant corporation attributable to absorbed constituent corporations would appear to be properly allowable, to the extent that they offset premerger income of such constituent corporations, in determining the tax liability to which the resultant corporation has succeeded.* These conclusions would seem also to be applicable with re-

spect to consolidations. See *Helvering v. Metropolitan Edison Company,* 306 U.S. 522, Ct. D. 1392, C.B. 1939-1 (Part 1), 229, in which, and in cases referred to therein, carry-overs of tax rights across the line of statutory corporate fusions were allowed without apparent regard to whether such statutory fusions were mergers or consolidations.

* * *

"Accordingly, absent any evasion or avoidance of tax within the purview of section 129 or other provisions of the 1939 Code, with respect to statutory mergers and consolidations the tax treatment of which is determined under such code, *it is held that . . . (2) the portion of the net operating losses and unused excess profits credits attributable to the assets acquired by the resultant corporation from an absorbed constituent and used in continuing the prefusion business of such absorbed constituent may be carried back, to the extent that they offset the prefusion income of the absorbed constituent, in determining, the tax liability to which the resultant corporation has succeeded;*" (Emphasis added).

In short, in Rev. Rul. 59-395 the Service ruled that in any statutory merger or consolidation, irrespective of the number of corporations involved or whether the corporations were brother-sister, parent-subsidiary, or for that matter, totally unrelated, postmerger losses could be carried back against prefusion income of the absorbed constituent corporations to the extent that the loss arose out of the same business conducted prior to the reorganization.

Thus, in Rev. Rul. 59-395 the Service ruled that, under the 1939 Code, the losses involved in a case such as those at bar could have been carried back in the manner contended for by Petitioner herein. Further elaboration in this regard will be made in the next section of this brief, but Petitioner desires to also emphasize this fact at this time since the Tax Court has evidenced such a grievous misapprehension of the ruling.

VIII.

The Tax Court Erred in Refusing to Hold, in the Alternative, That (a) the Merger Between Stauffer California and Stauffer New Mexico Constituted an "F" Reorganization, or (b) Each of the Three Mergers Constituted an Independent "F" Reorganization.

As heretofore observed, Petitioner contends, as it did before the Tax Court, that the holdings of the Tax Court in *Pridemark* and the Fifth Circuit in *Davant* are correct and should be followed in the cases here at bar. However, in the alternative, Petitioner contends, as it did before the Tax Court, than in any event, the rule of the Respondent in Rev. Rul. 58-422 properly requires that the facts here at bar be deemed to constitute an "F" reorganization of Stauffer California into Stauffer New Mexico, accompanied by two "A" reorganizations (under Section 368(a)(1)(A) of the Code) between Stauffer Illinois and Stauffer New York, respectively, and Stauffer New Mexico. In the further alternative, Petitioner contends, as it did before the Tax Court, that if the court decisions in *Pridemark* and *Davant*, and Respondent's ruling in Rev. Rul. 58-422, are all to be disregarded, then the facts of the cases here at bar should be properly be regarded as three "F"

reorganizations involving Stauffer California, Stauffer Illinois and Stauffer New York, respectively, and Stauffer New Mexico. The Tax Court summarily rejected each of the alternative contentions by Petitioner in the following language [Record, p. 234]:

> "Thus, the three old Stauffer companies merged into Stauffer New Mexico not *seriatim* but simultaneously. Either all three were parties to the 'F' reorganization or none were. The three mergers were interdependent. They cannot be fragmented, nor can one of them be singled out as an 'F' reorganization as was possible in the case of the parent corporation in Rev. Rul. 58-422."

Petitioner respectfully submits to this Court that the merger transactions in Rev. Rul. 58-422 were also effected simultaneously by the same merger document, as the Tax Court found was true here. There is no more reason to fragment the transactions in Rev. Rul. 58-422 than there is to fragment them in the cases here at bar. We further respectfully submit to this Court that, as pointed out earlier in this brief in discussing the recent *Dunlap & Associates, Inc.* case, the Tax Court has no difficulty in so fragmenting a transaction when it desires to do so, and the Internal Revenue Service obviously has no difficulty in so fragmenting a transaction when it desires to do so, as is evident from Rev. Rul. 58-422 and Rev. Rul. 59-395.

Notwithstanding the efforts by the Government and the Tax Court to obfuscate the issue, the real meaning of Rev. Rul. 58-422 is perfectly obvious. The taxpayer in Rev. Rul. 58-422 approached the Service with a very simple problem. He wanted to change the place of in-

corporation of his three corporations, and he also wanted to combine them into one corporation. It was much simpler to effect this objective in one statutory merger than it was to effect it by means of three separate transactions. Accordingly, he asked the Service to rule that combining the three transactions into one statutory merger would not affect the essence of the transaction.

The Service very sensibly ruled that there was no reason whatsoever why the taxpayer could not accomplish his three objectives in one step, and thus the Service issued the requested ruling. However, the Service was no doubt concerned about possible administrative complications which might arise if it considered the entire transaction to be an "F" reorganization, whereas the taxpayer was no doubt unconcerned whether the whole transaction was treated as an "F" reorganization or merely the reincorporation of the parent was treated as an "F" reorganization. Accordingly, the Service ruled that the transaction would be viewed as an "F" reorganization of the parent corporation and a tax-free liquidation of the subsidiary corporations.

It is important to note that even though the Service ruled that the transaction was an "F" reorganization only as to the parent corporation, the effect of this ruling was to permit all operating losses incurred by the successor corporation after the merger to be carried back against the premerger profits of the parent, irrespective of whether these operating losses were generated by the business formerly conducted by the parent, or were generated by the businesses formerly conducted by the subsidiaries. It is further important to recognize that there was nothing wrong in permitting

such a carryback of the postmerger losses of the successor corporation, irrespective of which of the three businesses created these losses, since this same objective could have been easily and undeniably accomplished had the taxpayer effected the merger transaction in several steps rather than in one merger transaction.[17]

The fact that a parent and two subsidiaries were involved in Rev. Rul. 58-422 was, we submit, entirely irrelevant to the problem. Exactly the same analysis would have been applied by the Service if the corporations involved had been brother-sister corporations.[18]

Why, then, does the Government insist upon denying similar treatment to the taxpayer in the cases here at bar? Assuming that the Government is not simply motivated by a desire to unjustly enrich the coffers of the Government, the answer to this can only be found in the fact that the taxpayer did not ask the Service before the transaction to rule on the "F" reorganization issue. Had the Government been asked to rule that the transaction amounted to an "F" reorganization as to Stauffer California, we submit that the Service would have unquestionably so ruled upon the strength of Rev. Rul. 58-422. To deny such a ruling to the taxpayer would have made no sense, since the taxpayer could then have effected the transaction in a number of other ways, any of which would have unquestionably accomplished the intended result.

The Government and the Tax Court seemingly read some malevolent motive in the fact that the taxpayer did request a ruling from the Service prior to the trans-

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[17]See footnote 21, *infra*, and text relating thereto.

[18]See discussion in preceding section of this brief. Also, this point will be further developed *infra* in this section.

action, but only requested an "A" reorganization ruling, and not an "F" reorganization ruling. However, it is evident that the disastrous operating losses were wholly unanticipated and thus there was no purpose in requesting an "F" reorganization ruling, since the transaction also qualified as an "A" reorganization. The record amply demonstrates that the decedent taxpayer was running an immensely successful business prior to the merger. It is further obvious from the portions of the record dealing with the valuation of inventory question, a strictly factual issue which is not before this Court [see Record, pp. 201-13], that the decedent taxpayer completely failed to recognize, or stubbornly refused to recognize, that due to competitive factors and Governmental attacks, his business had been critically injured prior to the merger. Said record further shows that the decedent taxpayer kept the facts of the cataclysmic deterioration of his business a well kept secret. It is self-evident that if his counsel had been given any inkling of the possibility of substantial business reverses, the merger would not have taken place, and certainly would not have taken place without a supplementary ruling covering the "F" reorganization point.

The issue boils down, therefore, as to whether the tax aspects of the transaction here at bar should depend upon whether or not the taxpayer announced to the Service beforehand that the transaction was intended to be an "F" reorganization. This, of course, cannot be.

But, says the Government, how do we know which of the three corporations the taxpayer intended to have the "F" reorganization with, unless the taxpayer announced his choice in advance? Again, the inference

is made that some malevolent objective can be accomplished unless the taxpayer is forced to announce his choice in advance. The Government reasons that if the taxpayer does not announce his choice in advance, he can retroactively pick which of the corporations he is to carry the losses back against. We submit that the Government is tilting windmills. First of all, at the date of merger the taxpayer would not even know that losess were going to be incurred. Secondly, if the taxpayer anticipated the possibility of losses, he probably would not be foolish enough to have entered into the merger. Thirdly, even if the taxpayer had anticipated that losses were going to be incurred, and did proceed with the merger, he would obviously have picked the company with the largest premerger profits to be the subject of the "F" reorganization. Accordingly, there is no doubt whatsoever which corporation is the subject of the "F" reorganization.

Again, we pause to emphasize that there is nothing wrong whatsoever with carrying back the losses incurred after the merger. Congress intended that this carryback should be permitted, and the carryback is legally, morally, and philosophically proper under the law.

Setting aside the fact that the California corporation would be the obvious choice for the "F" reorganization because of the fact that it had by far the most premerger profits, the record also conclusively demonstrates that for a number of other reasons the California corporation is the only logical choice:

(a) Stauffer California Was the Dominant Company in the Overall Stauffer Business.

The old Stauffer companies were the outgrowth of a California partnership, all of the stock of which was

owned by California residents. The home office of the overall business operation was at 1919 Vineburn, Los Angeles, California. From that office all major management directives were issued [Record, pp. 185-7].

When Mr. Stauffer was approached with regard to the relocation of his business in New Mexico, the California company considered, planned and prepared for the proposed relocation. The other companies participated in the transaction only through adoption of formal resolutions making themselves parties to the plan of reorganization. It was Stauffer California which purchased the land in Albuqurque which was to serve as the site of the business following the proposed relocations [Record, pp. 187-8, 191].

(b) Stauffer California Was by Far the Largest of the Companies.

By any objective standard Stauffer California was by far the largest of the three predecessor companies. For example, for the last fiscal year ended January 31, 1959, the tax returns of the respective companies [Ex. 16-J, 19-M, 22-P] show:[19]

(i) Stauffer California had about 75% of the total sales of the three companies;

(ii) It had almost 90% of the net income of the three companies;

(iii) It had over 70% of the combined net worth.

(iv) It had about ⅔ of the gross assets.

[19]These comparisons will, of course, vary depending upon the year selected, but there can be no doubt as to the conclusion that Stauffer California was by far the largest of the companies. The year ended January 31, 1959 has been selected since it was the last full year of operation prior to the merger.

It should be noted in this regard that Regs. §1.381(c)(4)-1(c)(2)(ii), dealing with the method of accounting to be utilized by the successor corporation in a tax-free transaction involving multiple corporations, provide that the company with the greatest gross assets and gross receipts will be deemed to be the dominant or controlling entity for this purpose, and, of course, Stauffer California would meet this test.

(c) Stauffer California Was the First of the Companies to Merge Into Stauffer New Mexico.

Although the Tax Court refused to so hold [Record, pp. 233-4], the evidence and findings of the Court [Record, p. 190] demonstrate Stauffer California was also the first of the companies to be merged. The Merger Agreement specifically contemplates three separate merger transactions [Ex. 7-A]. Under Paragraph 1 of the Merger Agreement it is provided that Stauffer California merge into Stauffer New Mexico, the merger to be effective upon the filing of the necessary papers with the governmental agencies of the states of New Mexico and California. Similarly, Paragraph 2 deals with the merger of Stauffer Illinois into Stauffer New Mexico, providing that that merger shall be effective upon the filing of the necessary documents with the governmental agencies of the states of New Mexico and Illinois. Paragraph 3 deals with the merger of New York and New Mexico.

Paragraph 6(E) of the Merger Agreement contemplates that the individual mergers would become effective at different times, defining the "effective date of the merger" as meaning "the effective date of the *last of the individual mergers* contemplated hereby to become effective if each thereof does not become ef-

fective on the same date, such single or latest date, as appropriate, being hereinafter referred to as the 'effective date of the merger' unless the context requires otherwise . . ."

As stipulated by the parties and found by the Tax Court [Record, p. 190], the Merger Agreement was filed in the office of the Secretary of State of the State of New Mexico early in the morning of October 1. The Merger Agreement had already been mailed to the Secretary of State of the State of California, and a telephone request for filing of the Agreement was made on the morning of October 1. Under California law, the filing was effective at that time.[20] Filing did not occur until 4:30 P.M. in the State of New York, and 5:00 P.M. in the State of Illinois.

Thus it is clear that, under the rationale of Rev. Rul. 58-422, Stauffer California must be deemed to have participated in an "F" reorganization since Stauffer California (i) had by far the most premerger profits, (ii) was otherwise in all respects the dominant company, and (iii) was the first of the companies to merge into Stauffer New Mexico.

We can anticipate, however, an anguished cry from the Government that the choice in other situations may not be as simple as it is in the cases here at bar. To such a cry, we would respond by saying that the courts have more than adequate ability to solve this problem if the occasion arises, and the inconvenience of facing up to this theoretical problem cannot conceivably justify the frustration of the statutory pur-

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[20]An instrument is "filed" when it is deposited in the proper office, for the purpose of filing the same. *Edwards v. Grand* (1898), 121 Cal 254; *Cox v. Tyrone Power Enterprises* (1942), 49 Cal. App. 2d 383, 395.

poses nor can it conceivably justify the outrageous penalty which is being exacted from the taxpayer herein as a result of the Tax Court decision.

We submit that thers can be no doubt as to the applicability of Rev. Rul. 58-422 to the cases at bar. Actually, the only difficult aspect of Rev. Rul. 58-422 is trying to synthesize the holding of that ruling with the Government's position in the "liquidation-reincorporation" cases, and with the holdings of the Tax Court in *Pridemark* and the Fifth Circuit in *Davant*. Rev. Rul. 58-422, of course, adopts a somewhat narrower concept than that adopted by the Government and the Courts in the "liquidation-reincorporation" area, since Rev. Rul. 58-422 considers only one of the three corporations to be the participant in the "F" reorganization, whereas in the "liquidation-reincorporation" area all three corporations would be deemed to be parties to the "F" reorganization. As previously noted, the effect of Rev. Rul. 58-422 is to permit a carryback of postmerger losses irrespective of which of the three businesses incurred these losses, but to require that losses be carried back only against the profits of one of the three businesses.

It seems apparent that Rev. Rul. 58-422 was adopted prior to the time that the Government fully thought through the "F" reorganization provisions in connection with its contentions in the "liquidation-reincorporation" area, and that Rev. Rul. 58-422 is an unduly narrow construction of the law. The Tax Court holding in *Pridemark* and the Fifth Circuit in *Davant* properly interpret the law. The Government seemingly infers that there is something immoral in permitting the successor corporation to carry back postmerger losses against

profits of all of the predecessor corporations. We submit, however, that there is no such immorality in permitting this result, since an "F" reorganization requires a factual situation in which there has been no substantial change in business or ownership as a result of the reorganization. Under these circumstances, it is eminently reasonable to permit a carryback of the post-merger losses against profits of all of the predecessor corporations.

In actuality, the holding of the Tax Court merely penalizes the innocent and unwary. Any taxpayer who anticipates future losses and who desires to carry those losses back against the profits of more than one of his corporations can easily plan to accomplish this result. To illustrate: If a taxpayer owns corporations A and B and anticipates losses in B which he wishes to carry back against the profits of A, he simply merges B into A. If B has its own previous profits which he also wishes to carry the losses back against, he simply waits until B's losses are sufficient to offset the previous profits of B, and then merges B into A. If he also wishes to change the place of incorporation of the corporations, he simply does so either before or after the merger transaction. Through this elementary planning, the carrybacks would be unquestionably available.[21] Thus, the effect of the Tax Court decision is

[21] If no change in the place of incorporation is made, but B is merely moved into A, the surviving corporate entity, A, can routinely carry back the loss pursuant to Section 172 of the Code. The fact that the loss might arise from the business formerly conducted by B is immaterial. Rev. Rul. 66-214, 1966-2 C.B. 98 (although this ruling involved carryovers, it would equally apply to carrybacks). If A's place of incorporation is changed by, for example, merging A into a newly formed corporation, C, incorporated in another state, and this is done either

(This footnote is continued on the next page)

to unnecessarily penalize the innocent, a result which obviously cannot be sound.

But setting aside the propriety of the holdings in *Pridemark* and *Davant,* and setting aside the holding of Rev. Rul. 58-422, there is a third, albeit narrower, approach to the facts herein, and that is to treat the three mergers as three separate "F" reorganizations. There is, of course, absolutely no reason why three "F" reorganizations cannot occur simultaneously and be analyzed as such. Such an analysis would meet the objective sought by the Courts in *Pridemark* and *Davant,* since the holdings of the Courts in those cases would not have changed one whit whether the transaction had been viewed as one "F" reorganization or three "F" reorganizations. However, the only advantage in viewing the transactions as three "F" reorganizations rather than one "F" reorganization would be if this Court were to consider that *Libson Shops* principles should be applied even under the 1954 Code in the case of carryback claims arising out of an "F" reorganization. Under this reasoning, the Court would limit the carryback to the premerger income of the same business, a rule which is narrower than the rule in *Pridemark* and *Davant,* or Rev. Rul. 58-422, but is certainly more sensible than requiring a complete forfeiture of the carryback. While Petitioner does not believe that the adoption of this narrow rule is the soundest position for this Court to take, since there is no reason to infer that Congress intended any such restriction, nonetheless, as a precaution, Petitioner has introduced suf-

before or after the merger of B into A, the merger of A into C would constitute a classic "F" reorganization even under the Government's theory. Therefore, under Section 381(b)(3) of the Code, C would be entitled to the same carryback rights as A would have had in the absence of the merger.

ficient evidence before the Tax Court so that, under any reasonable interpretation of *Libson Shops* principles, the tracing of premerger income and postmerger losses has been established [Record, pp. 193-197]. Although the Tax Court notes that the breakdown of postmerger losses is in one respect "not strictly" comparable [Record, p. 197] with corresponding premerger income, we respectfully submit that the evidence is sufficient to satisfy the rationale of *Libson Shops,* were such rationale deemed to be applicable to the cases at bar.

IX.

Conclusion.

In summary, no matter which of the above alternative theories were deemed to be applicable, Petitioner is entitled to prevail herein. Petitioner's views as to the proper approach have been detailed earlier in this brief and will not be reiterated here. Inasmuch as Petitioner is entitled to prevail under any of the alternative theories, it is not actually necessary for this Court to make a choice as to which is the proper theory at this time. Indeed, since the move to New Mexico was never implemented, and thus the fusion which occurred was merely a conceptual legal fusion rather than an actual fusion, this Court need not even determine how it would hold if an actual fusion had occurred. Any of the legal theories outlined above can arguably be supported as a reasonable construction of the law. The one theory, however, that cannot be supported as a reasonable interpretation of the law is the theory adopted by the Tax Court in its decision below.

We do not deny that the Tax Court's decision is the most convenient solution to the issue here at bar. Ob-

viously, there can be no problems in administering the carryback if the carryback is not permitted. Neither do we deny that complications may conceivably arise in the event Petitioner prevails herein. We do, however, emphatically deny that the Tax Court's decision properly construes the law. We agree with the Tax Court that the Code is an "extraordinarily complex and sensitive instrument." [Record, p. 230]. We disagree, however, with the Court's myopic conclusion that the statute must be narrowly construed so as to avoid "unintended difficulties." [Record, p. 230]. We venture to say that there always have been and will always be "unintended difficulties" in administering a statutory scheme of such gigantic proportions.[22] Congress could

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[22]We must also respectfully remind this Court that the courts often expend herculean efforts to stretch the literal language of the statutes in order to implement the intent of Congress. In short, the concept of "unintended difficulties" is a two-way street. Take, for example, the "liquidation-reincorporation" area, and the "unintended difficulties" which have been encountered in implementing the Congressional intent. Consider how mightily the courts are struggling to patch the statutory imperfections. The following language of the Fifth Circuit in the *Davant* case (at p. 887 fn. 27) is significant in this regard:

> "Petitioners have cited us to a number of cases where the courts have construed the reorganization provisions with strict literalness without regard to the fact that it defeated the purpose of the tax statute. Each time, Congress acted to close the judicially created loophole. *From this interchange of events, petitioner asks us to draw the conclusion that the courts should always permit tax evasion when a literal application of the Code will minimize tax consequences regardless of the true economic realities. We draw just the opposite conclusion. Having been consistently rebuked by Congress in this area whenever we departed from the inherent purpose of the statutory scheme, we should avoid making the same mistakes and, instead, utilize all our efforts to apply the Code as Congress intended.* The problem created for Congress if the courts adopt any other approach to the reorganization provisions is made painfully apparent by this litigation. The statute must be narrow enough to prevent sales being made to look

not conceivably have anticipated all of the legal and factual permutations and combinations. The proper construction of the statute cannot be found by a meaningless semantic debate, but must be found by analyzing the purpose of the loss carryover and carryback provisions. This purpose is eminently clear. As the Supreme Court so aptly stated in *Libson Shops* (at p. 386):

> "Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to setoff its lean years against its lush years, and to strike something like an average taxable income over a period longer than one year. [Footnote omitted]."

Petitioner herein is the clasic example of the reason for the loss carryback and carryover provisions,[23] and is manifestly entitled to prevail herein.

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like reorganizations and broad enough to prevent reorganizations being made to look like sales. *Had the courts adhered to obvious legislative intent and not felt restricted to a literal and rather restrained interpretation, there would have been no necessity for Congress to enact the detailed, almost impossible to follow, complicated reorganization provisions which now confront us.* The rules could be simple: 1) those who genuinely participate in reorganizations would get the tax deferment Congress intended; 2) those who sell property or withdraw earnings would be taxed as Congress intended. *The considerations underlying the reorganization provisions were not cast in terms of form but of substance. Courts in performing their judicial duty must take notice of this fact. See Bazley v. Commissioner* [47-1 USTC ¶9288], 331 U.S. 737 (1947)." [Emphasis added].

[23]The language and holding of the First Circuit in *F.C. Donovan, Inc. v. U.S.* (1st Cir. 1960), 261 F.2d 470 is particularly appropriate here. F. C. Donovan, Inc. was engaged in merchandising leather at wholesale prior to 1945-46. It had a wholly-owned subsidiary, Plastic Products Co., engaged in the

(This footnote is continued on the next page)

THE "ERRONEOUS ASSESSMENT" ISSUE.

I.

The Tax Court Erred in Permitting the "Erroneous Refund" Paid to Stauffer New Mexico to Be Included as an Element of the Deficiency of Stauffer California. Such Refund, Having Been Claimed by and Paid to Stauffer New Mexico, Must Be Recovered From Stauffer New Mexico.

The second major issue involved in this proceeding stems from the fact that $1,695,125.30[24] of the amount

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business of distributing plastic sheeting. In December, 1946, Plastic Products Co. was merged into its parent, in a transaction that did not constitute a statutory merger under Massachusetts law. The Board of Directors of each corporation merely approved an agreement that all assets of the subsidiary should be transferred to the parent and the subsidiary's stock canceled.

After the merger, the corporation sustained a net operating loss which it sought to carry back against premerger income of Plastic Products Co.

The Court allowed the loss carryback and approved their prior case of *Newmarket Manufacturing Co.* (*supra*) emphasizing the "economic business identity" between the surviving unit and the prior two units. In this regard the Court said (at p. 472):

> "The government argues, therefore, that the Newmarket case is not controlling here, where 'more than one business was involved.' But we thought we had made it clear enough in the Newmarket case what we took to be of paramount importance, that the *ownership and all other practically important attributes of the business* which suffered the loss in 1952 and the business which had earned income in the previous year were unchanged. This is also true in the present case. It was in that context that we referred to the congressional desire, in enacting the carry-back privilege, to bring stability to the tax burden of 'a business with alternating profit and loss.' (233 F.2d at page 497.) And we thought that the Congress must have had in mind, in this connection, the burden *not of an artificial legal entity* called a corporation *but* 'that of *the human beings doing business behind the corporate facade* and who, alone, actually feel the pinch of taxation'." [Emphasis added].

[24]Although the actual amount of the refund was $1,744,847, only $1,695,125.30 (*i.e.*, $1,481,653.05 for the fiscal year 1958, and $213,472.25 for the fiscal year 1959) is included in the

claimed in this proceeding to be a deficiency of Stauffer California actually represents moneys refunded to Stauffer New Mexico in connection with the carryback claim filed after the merger on its own behalf. Petitioner's contention in this regard is very simple. The money was refunded to Stauffer New Mexico. Stauffer New Mexico is not a party to this proceeding. Petitioner has not in this proceeding been assessed as the transferee of a primary tax obligation of Stauffer New Mexico. A refund paid to Stauffer New Mexico can only be asserted against Stauffer New Mexico. The Government has no right to include an erroneous refund paid to Stauffer New Mexico as a part of the deficiency[25] of Stauffer California which has been held to be an entirely different taxpayer than Stauffer New Mexico. In order for the amount of the refund to be a part of the deficiency of Stauffer California, the refund claim had to have been filed by or on behalf of Stauffer California, and it was not; it was filed by Stauffer New Mexico on its own behalf

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deficiency because a $49,721.70 assessment which had previously been paid was credited against the deficiency [Record, p. 241, fn. 13].

[25]Section 6211 of the Code provides, in part, as follows:

"Definition of a Deficiency.

(a) In General.— . . . the term 'deficiency' means the amount by which the tax imposed by subtitles A or B exceeds the excess of—

(1) the sum of

(A) The amount shown as the tax by the taxpayer upon his return, [over] . . .

(2) the amount of rebates, as defined in subsection (b)(2), made.

* * *

(b)(2) The term 'rebate' means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed by subtitles A or B was less than the excess of the amount specified in subsection (a)(1) over the rebates previously made."

Ex. 25-S] and the refund was made to Stauffer New Mexico on its own behalf [Exs. 26-T, 26-U].

In response to this contention, the Tax Court, which on the "F" reorganization issue had doggedly impaled the taxpayer upon a tenuous reed of legal technicalities, dismissed this contention as "without merit." The Court stated as follows [Record, p. 241]:

> "While it is quite true that Stauffer New Mexico cannot be regarded as the same taxpayer as Stauffer California under section 368(a)(1)(F), it was nevertheless the successor to Stauffer California as the result of a statutory merger under Section 368(a)(1)(A) and had full standing to apply for and receive a refund of Stauffer California's taxes. Rev. Rul. 54-17, 1954-1 C.B. 160. If such refund were erroneously made, as was the situation in this case, there resulted a deficiency in Stauffer California's taxes (not Stauffer New Mexico's taxes), which the Commissioner was entitled to collect from the ultimate transferee of Stauffer California's assets, namely, the petitioner herein. To be sure, the claim for refund should have identified Stauffer California as the taxpayer, but there was never any doubt that the refund sought and received related to taxes paid by Stauffer California. Stauffer New Mexico was not even in existence during the two fiscal years in question, and it is difficult to see how the Commissioner could have determined deficiencies against it in respect of the improper refund. When that refund was made, deficiencies arose in Stauffer California's taxes for its fiscal years 1958 and 1959.

> We hold that the Commissioner proceeded properly in determining the deficiencies and transferee liability herein."

Although it is perfectly true, as stated by the Tax Court, that Rev. Rul. 54-17 permits a successor corporation to claim a refund on behalf of its predecessor corporation which has overpaid its income taxes, Rev. Rul. 54-17 requires that any claim for refund on behalf of a predecessor corporation must be executed "in the name of, and on behalf of, the corporation which paid such taxes" and must file proper evidence establishing its successor status. This was not done. The refund claim filed by Stauffer New Mexico was filed in Stauffer New Mexico's own name, with absolutely no reference whatsoever to Stauffer California (or either of the other predecessor corporations) [Record, p. 198].

Further, although the Tax Court peremptorily concludes that the refund claim should be conclusively deemed to have been filed by Stauffer California, Section 381(b)(3) does not purport to give the right to a refund to Stauffer California. Section 381(b)(3) gives the right to carry back to the "corporation acquiring property in a distribution or transfer described in subsection (a)" (an "F" reorganization being one of the transactions described in said subsection (a)).[26] Thus, the right to a refund under the statute was vested in Stauffer New Mexico, not Stauffer California.

It is thus eminently clear that the refund paid to Stauffer New Mexico cannot lawfully be included as

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[26]See text of statute in footnote 1.

part of the deficiency of Stauffer California. Stauffer New Mexico was the only corporation entitled to a refund, and accordingly it could not possibly have filed a refund claim on behalf of Stauffer California. Moreover, Stauffer New Mexico did not attempt to file a claim on behalf of Stauffer California, and thus there is no basis whatsoever for imputing such an act to Stauffer New Mexico.[27]

The fallacy of the Tax Court's reasoning can also be demonstrated in still another way. It is undisputed that Petitioner is only liable in this proceeding as a "double" transferee, that is, as transferee of Stauffer New Mexico, which was, in turn, a transferee of Stauffer California. Thus, in order to hold Petitioner liable as a transferee of Stauffer New Mexico, as transferee, it is necessary to determine that Stauffer New Mexico is itself a transferee. The basis for transferee liability must be found in Section 6901(a)(1)(A) of the Code, which defines transferee liability as "the liability at law, or in equity, of a transferee of property."[28] It is axiomatic that in order for

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[27]It is further obvious from the statutory notice of deficiency [Record, pp. 120-123] that the Government fully intended to assess the refund paid to Stauffer New Mexico as a deficiency of Stauffer California, and thus the Government cannot claim that there was a mere error in identifying the party. This is no case of mere "misnomer." Respondent, having acted exactly as it intended to act, cannot justify its issuance of a statutory notice of transferee liability which asserts a deficiency against a taxpayer who, under the holding of the Tax Court, is manifestly not liable for any tax. Such an effort was made by the Government and rejected in *Wayne Body Corp.* (1931), 22 B.T.A. 404, 414-415 (Acq. X-2 C.B. 74) and in *Reef Corp.* (1965), 24 T.C.M. 379, 391-2, aff'd. (5th Cir. 1966), 368 F.2d 125; cert. den. 386 U.S. 1018.

[28]Section 6901(a) of the Code provides, in part, as follows:

"(a) Method of Collection.—The amounts of the following liabilities shall, except as hereinafter in this section

Stauffer New Mexico to have transferee liability, there must have been an obligation of Stauffer New Mexico, whether choate or inchoate, existent on the date of merger of Stauffer California into Stauffer New Mexcio. Under California law, the corporate existence of Stauffer California ceased on the date of merger.[29] It is obvious from the facts in this proceeding that the liability for the erroneous tax refund could not possibly have been an obligation, either choate or inchoate, of Stauffer California on the date of merger, since the liability stems solely from facts occurring long after the date of merger. The carryback claim originated from losses incurred by Stauffer New Mexico more than one year after the date of merger. At the time the losses were incurred and at the time the refund claim was filed there was no Stauffer California, Stauffer California having ceased to exist on the date of merger. To hold that Stauffer New Mexico is liable as a transferee under these facts is not conceptually possible. The refund claim could only have been filed by Stauffer New Mexico, the refund could only have been paid to Stauffer New Mexico. The remedy of the Government is to proceed against Stauffer New Mexico, and it cannot properly claim that the

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provided, be assessed, paid and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred:

(1) Income, estate and gift taxes.—

(a) Transferees.—The liability, at law or in equity, of a transferee of property—

(i) of a taxpayer in the case of a tax imposed by subtitle A (relating to income taxes), * * *"

[29]Section 4116 of the California Corporations Code provides in part as follows: "Upon merger or consolidation pursuant to this article, the separate existence of the constituent corporations ceases . . ."

erroneous refund was a part of the deficiency of Stauffer California.[30]

Respectfully submitted,

Gibson, Dunn & Crutcher,
By Norman B. Barker,
Attorneys for Petitioner.

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[30]This Court should be made aware of the fact that the Government has various procedural techniques available for recapturing erroneous refunds In this proceeding, the Government is attempting to recoup the amount under the "deficiency" procedure provided for in Section 6211 of the Code (See footnote 25). However, the Government could have also proceeded under the "mathematical error" procedure provided for in Section 6213(b)(2) of the Code, which it did not. Section 6213 (b)(2) provides as follows:

> "(b)(2) Assessments Arising Out of Tentative Carryback Adjustments.—If the Secretary or his delegate determines that the amount applied, credited, or refunded under section 6411 is in excess of the overassessment attributable to the carryback with respect to which such amount was applied, credited, or refunded, he may assess the amount of the excess as a deficiency as if it were due to a mathematical error appearing on the return."

Further, the Government can commence an action for the recovery of the erroneous refund under Section 7405(b) of the Code. Section 7405(b) provides as follows:

> "(b) Refunds Otherwise Erroneous.—Any portion of a tax imposed by this title which has been erroneously refunded . . . may be recovered by civil action brought in the name of the United States."

In fact, the Government has such an action presently pending in the United States District Court for the Southern District of California, Central Division, Civil Action No. 66-663-AAH, United States of America, plaintiff, vs. Stauffer Reducing, Inc. of New York; Stauffer Reducing, Inc. of Illinois; Stauffer Reducing, Inc. of California; Stauffer Laboratories, Inc.; and Bonnie H. Stauffer, individually and as Executrix of the Estate of Bernard H. Stauffer, Deceased, defendants. That case is presently being held in abeyance pending the result of this proceeding.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

Norman B. Barker

Nos. 22277, 22277A and 22277B

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ESTATE OF BERNARD H. STAUFFER, BONNIE H. STAUFFER, EXECUTRIX,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 180-242) are reported at 48 T.C. 277.

JURISDICTION

This consolidated petition for review (I-R. 252-258) involves petitioner's liability for the federal income taxes of: Stauffer Reducing, Inc., of California for the fiscal years ending January 31, 1958 and January 31, 1959, and the eight-month period ending on September 30, 1959, in the total amount of $2,107,146.49; Stauffer Reducing, Inc. (Illinois), for the eight-month period ending September 30, 1959, in the amount of $340,822.82; and

Stauffer Reducing, Inc., of New York for the eight-month period ending September 30, 1959, in the amount of $6,943.95. On June 28, 1963, the Commissioner of Internal Revenue mailed notices of deficiencies, asserting deficiencies in those taxes. (I-R, 15-17, 48-50, 120-123.) Within ninety days thereafter, on September 23, 1963, petitioner filed petitions with the Tax Court for a re-determination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-12, 35-46, 66-76.) The decisions of the Tax Court were entered June 14, 1967. (I-R. 243-245.) The case is brought to this Court by consolidated petitions for review filed September 5, 1967 (I-R. 252-258), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and Regulations are set out in the Appendix, infra.

QUESTIONS PRESENTED

1. Section 381(b) of the Internal Revenue Code of 1954 provides that a corporation which transfers its assets to another corporation pursuant to certain types of tax-free reorganizations must end its taxable year on the date of the transfer, and that the transferee corporation may not carry back a net operating loss for a taxable year ending after the transfer to a taxable year of the transferor corporation, "except" in the case of a reorganization as defined in Section 368(a)(1)(F), i.e. "a mere change in identity,

form, or place of organization" of the transferor corporation.

The question is whether the simultaneous merger of three separate corporations carrying on separate businesses in different areas into a newly created corporation constituted an "F" reorganization ("a mere change in identity, form, or place of organization") so as to come within the exception provision of Section 381(b) as the taxpayer contends, or solely an "A" reorganization ("a statutory merger or consolidation"), as the Tax Court unanimously held.

2. Whether the Tax Court correctly held that a refund to the new corporation of taxes paid by one of the merged corporations (Stauffer California), pursuant to an application under Code Section 6411 for tentative allowance of a carryback of the new corporation's post merger net operating loss against the pre-merger income of the merged corporation, resulted in deficiencies in the latter's taxes under Section 6211.

STATEMENT

The facts as stipulated (I-R. 152-171) were incorporated in its findings of fact by the Tax Court (I-R. 182). Its findings of fact (I-R. 182-213) may be summarized as follows:

In July 1958, Bernard H. Stauffer became the sole shareholder of three corporations engaged in the sale of a patented weight control machine. The corporations were Stauffer Reducing, Inc., of California (Stauffer California), which operated in the Western

United States; Stauffer Reducing, Inc., an Illinois corporation (Stauffer Illinois), which conducted its business in the Midwest; and Stauffer Reducing, Inc., of New York (Stauffer New York), which carried on activities in the Northeastern United States. During the latter part of 1958, Mr. Stauffer was solicited by representatives of Deming and Albuquerque, New Mexico, to relocate in those cities. It was decided to relocate in Albuquerque, and an option to purchase an industrial site nearby was acquired by Stauffer California. (I-R. 184-186, 187-188.)

In connection with the relocation, Mr. Stauffer formed a New Mexico corporation, Stauffer Laboratories, Inc. (Stauffer New Mexico), in which he was the sole stockholder. A plan of reorganization was formulated whereby the three old companies would merge into Stauffer New Mexico on October 1, 1959. In proposing the plan to the board of directors of Stauffer California, Mr. Stauffer stated that the merger was advisable (I-R. 188)--

> in view of the possibility of effecting substantial reductions in manufacturing and overhead costs through the combination of all of the facilities and operations in one central location, to the greatest extent possible, and the coordination of supervisorial activities. Further, it would be possible through the merger to bring all of the activities of the business within a single corporate body subject to the jurisdiction of the State of New Mexico, in which State most of the assets of the business would be located.

The formal merger agreement was approved by Mr. Stauffer in his capacity as sole stockholder of the four corporations and was

executed by him and his wife on September 28, 1959, in their respective capacities as president and secretary of each company. On or about September 29, 1959, Stauffer California exercised the option to acquire the site near Albuquerque at a price of $130,500. Title was taken in the name of Stauffer New Mexico by deed recorded on October 1, 1959. (I-R. 188-189, 191.)

The terms of the merger agreement were: (1) that each of the three old companies would merge with Stauffer New Mexico, the surviving corporation, pursuant to the laws relating to statutory mergers of the four states; (2) that the stated capital, paid-in surplus and retained earnings of Stauffer New Mexico would equal those of the three constituent companies; (3) that all property of the three constituent corporations would be vested in Stauffer New Mexico, which would be responsible for all liabilities and obligations of the three constituent corporations; and (4) that on the effective date of the merger the separate existence of the three constituent corporations would cease. The merger agreement further provided that it would not become effective or binding upon any of the constituent corporations, their officers or shareholders until a copy of the agreement and any other certificates or documents required by law were properly filed and recorded with the proper governmental agencies in each of the four states involved. (I-R. 189.)

The merger was effected on October 1, 1959, in accordance with the terms of the agreement. The agreement was filed with the Secretary of State of New Mexico early in the morning of that day, and was thereafter filed that same day in the appropriate agencies of the other three states (California, Illinois and New York). On issuance of additional stock of Stauffer New Mexico to Mr. Stauffer in respect of the stock of each of the constituent corporations, Mr. Stauffer remained the sole shareholder of Stauffer New Mexico. (I-R. 189, 190.)

Prior to the merger, on or about August 13, 1959, a request had been made of the Internal Revenue Service as to the tax consequences of the proposed reorganization. The Service was asked to rule that it would constitute a reorganization within the meaning of Section 368(a)(1)(A) of the 1954 Code (a statutory merger or consolidation). There was no request for any ruling as to whether the proposed merger would also qualify under Section 368(a)(1)(F) ("a mere change in identity, form, or place of organization, however effected"). On September 14, 1959, the Service ruled that the proposed merger would be a reorganization under Section 368(a)(1)(A). (I-R. 190-191.)

Because of business reversals, the contemplated Albuquerque relocation was never carried out. Stauffer New Mexico's principal place of business was in Los Angeles at what had previously been the main office of Stauffer California. Stauffer New Mexico

continued to carry on the operations previously conducted by the old companies from the same locations as before the merger. The accounting records continued to be broken down as though the three old companies were still in existence, except that no intercompany profits appeared on the books. (I-R. 191.)

Stauffer New Mexico was liquidated on January 31, 1961, and its assets, subject to its liabilities, were distributed to Mr. Stauffer, who thereafter continued the same business operations as a sole proprietor. (I-R. 192.)

Prior to the 1959 merger, the three old companies had filed separate corporate returns and had reported income on a fiscal year basis (February 1 to January 31). However, none filed closing tax returns for the period from February 1, 1959, the beginning of the new fiscal year, to September 30, 1959, the last day of their separate existence. It was originally intended that the old companies would file closing returns, as a request for an extension of the time for filing was made along with payments of taxes. (I-R. 192.)

Instead of filing closing returns for the old Stauffer companies, a return was filed in the name of Stauffer New Mexico which combined the operations of the old Stauffer companies and Stauffer New Mexico for the period February 1, 1959, to January 31, 1960. An Internal Revenue Service audit in 1960 did not contest the filing of a single return. (I-R. 192, 195.) In its closing

income tax return for the next fiscal year (ended January 31, 1961), Stauffer New Mexico reported a net operating loss of $3,366,052. And in an application for a tentative carryback adjustment, filed April 10, 1961, Stauffer New Mexico requested a refund of $1,481,653, consisting of all income taxes theretofore paid by Stauffer California for the year ended January 31, 1958, and $263,194 of the income taxes paid by Stauffer California with respect to the year ended January 31, 1959.[1/] Under Section 6411 of the 1954 Code, the Commissioner is authorized to make a refund within 90 days of such an application subject to a limited examination to determine whether omissions or errors of computation have been made. On this basis, a so-called "quickie" refund was allowed in the claimed amounts plus interest. The checks were drawn to Stauffer New Mexico, and were negotiated by Bernard H. Stauffer as trustee in dissolution and former sole shareholder of the then-dissolved New Mexico corporation. (I-R. 196, 198-199.)

Mr. Stauffer, acting as trustee in dissolution and former president and sole shareholder of Stauffer New Mexico, executed a document entitled "Transferee Agreement-Corporation" (Form 2045) on behalf of Stauffer New Mexico. Stauffer California was

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1/ The application did not, however, specifically identify Stauffer California. (I-R. 198.)

denominated as transferor and Stauffer New Mexico as transferee in this document. It read in part as follows (I-R. 200):

> In consideration of the Commissioner of Internal Revenue not issuing a statutory notice of deficiency to and making an assessment against the above-named transferor corporation, the undersigned admits that it is the transferee of assets received from said transferor corporation, and assumes and agrees to pay the amount of any and all Federal income, excess-profits, or profits taxes finally determined or adjudged as due and payable by the above-named transferor corporation for the taxable year (or years) ended 1/31/58 and 1/31/59, to the extent of its liability at law or in equity, as a transferee within the meaning of Section 6901 of the Internal Revenue Code of 1954 and corresponding provisions of prior internal revenue laws; * * *

The Commissioner determined deficiencies against the three old companies based on their failure to file closing returns for the eight-month period prior to the merger, and against Stauffer California based on disallowance of the carryback of the net operating loss of Stauffer New Mexico. The notices of deficiency were sent to Mr. Stauffer as the ultimate transferee of the assets of the three old companies. As Mr. Stauffer died shortly after the issuance of the notices of deficiency, his estate, the petitioner here, instituted suits in the Tax Court for a redetermination. Petitioner conceded the liability of Mr. Stauffer as transferee of the three old companies. (I-R. 182-183.)

The Tax Court, in a reviewed decision (per Judge Raum), unanimously rejected petitioner's claim that the merger of the old Stauffer companies into Stauffer New Mexico was a reorganization within

the meaning of Section 368(a)(1)(F) of the 1954 Code. Consequently, under Section 381(b) of the Code, the old Stauffer companies were required to file closing returns and no carryback of Stauffer New Mexico's net operating loss was allowable to offset the pre-merger income of the old companies. (I-R. 35-55.) Petitioner alternatively contended that, if the merger did not qualify as an "F" reorganization, no deficiency arose in Stauffer California's income taxes as a result of the net operating loss carrybacks. Petitioner's view rested on the ground that Stauffer New Mexico is to be regarded as a stranger to Stauffer California; hence, there was an erroneous refund of Stauffer California's taxes for which only Stauffer New Mexico is liable. Judge Raum held, to the contrary, that Stauffer New Mexico, as the successor of Stauffer California, had standing to claim the refund of Stauffer California's taxes, and therefore a deficiency did arise in the tax liability of Stauffer California. (I-R. 239-242.) 2/

2/ A second alternative issue raised by petitioner in the Tax Court, concerning a write-down of inventory (I-R. 235-239), has been abandoned in this Court.

SUMMARY OF ARGUMENT

I

While Congress has accorded nonrecognition of gain or loss treatment to all corporate "reorganizations" as defined in subparagraphs A to F of Section 368(a)(1) of the 1954 Code, it has expressly declined to treat all reorganizations alike for other tax purposes. In Section 381 it set out in detail the extent to which the "acquiring corporation" in certain tax-free "reorganizations" (those defined in Section 368(a)(1)(A), (C), (D), and (F)) may "succeed to and take into account" specified tax "items" of the transferor corporation. Section 381(a) sets forth the general rule, "subject to the conditions and limitations specified in subsections (b) and (c)". Subsection (c) lists the particular items to which the general rule applies (e.g. net operating loss carryovers, earnings and profits, methods of accounting, inventories, depreciation allowances). Subsection (b), captioned "Operating Rules", contains additional limitations: it requires that the taxable year of the transferor corporation shall end on the date of the transfer (Section 381(b)(1)), and it precludes the acquiring corporation from carrying back a net operating loss for a taxable year ending after the reorganization transfer to a taxable year of the transferor corporation (Section 381(b)(3)), "except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of Section 368(a)(1)". Section 368(a)(1) in turn defines an "F" reorganization as "a mere change in identity, form, or place of organization, however effected."

Accordingly, under the express terms of Section 381, the taxable year of the transferor corporation terminates, and a net operating loss carryback privilege otherwise available to a corporation under Section 172 is not available, even in the case of a tax-free reorganization, <u>unless</u> the reorganization qualifies as an "F" type.

In this case, three separate corporations (Stauffer California, Stauffer Illinois, and Stauffer New York), carrying on separate businesses in different geographical areas, were simultaneously merged under the applicable state laws into a new corporation (Stauffer New Mexico), having the same sole stockholder as its predecessors, and the separate businesses formerly carried on by the several merged transferor corporations were combined and thereafter conducted as one by the transferee corporation. In a unanimous and carefully reasoned opinion sustaining the Commissioner's determination, the Tax Court held that the merger constituted an "A" reorganization only ("a statutory merger or consolidation"), not an "F" reorganization ("a mere change in identity, form, or place of organization"), and therefore did not come within the exception provision of Section 381(b). In so holding, the Tax Court reached the only conclusion compatible with the terms and history of Section 381, the terms and history of the reorganization definitions in Section 368(a), the inter-relationship of those sections and other sections of the Code, the applicable Treasury Regulations, and the relevant decisions.

The reason for the statutory exception in Section 381(b) in favor of "F" reorganizations is apparent from the very statutory

description of that kind of reorganization as compared with other kinds (subparagraphs A through E of Section 368(a)(1)). The definition of an "F" reorganization--"a mere change in identity, form or place of organization"--is stricter than that of other types; it is limited to mere formalistic changes in the charter or place of organization of a single corporate enterprise, such as reincorporation in another state, and does not encompass an amalgamation of multiple operating corporations. In the few instances in which the "F" reorganization definition was applied up to the time of its inclusion in the 1954 Code, it was applied to the reincorporation of a single corporate enterprise, and it was in that setting that Congress re-enacted the definition in Section 368 and incorporated it by reference in Section 381. In harmony with the legislative history of Section 381 (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 275-277) and the more rigorous definitional requirements of an "F" reorganization, the long standing Treasury Regulations provide that only in the case of a reorganization qualifying under subparagraph F of Section 368(a)(1), i.e. only where there is a "mere" formalistic change in a single corporate enterprise, will the "acquiring corporation" be treated for purposes of Section 381(b) "just as the transferor corporation would have been treated if there had been no reorganization". Regulations Section 1.381(b)-1(a)(2). And it is abundantly clear from the examples given in the explanatory Senate Finance Committee Report and the Treasury Regulations that a merger or consolidation of two or more operating companies constitutes an "A" reorganization, not an "F" reorganization, for purposes of applying the exception

provision of Section 381(b). S. Rep. No. 1622, _supra_, p. 276; Regulations Section 1.381(c)(1)-1(b).

Unless the Congressional distinction between an "F" vis-a-vis an "A" reorganization is to be obliterated, an "F" reorganization is necessarily limited to the reorganization of a single corporation, and does not embrace a fusion of two or more operating corporations. Wherever the demarcation line between an "A" and an "F" reorganization is to be drawn, it is plain that an amalgamation of two or more corporate ventures into a single corporate enterprise is more than an "F" reorganization ("a mere change in identity, form, or place of organization"), and falls on the "A" side of the line ("a statutory merger or consolidation"). While the merger of a single corporation into a newly created one (reincorporation) may qualify as both an "A" and "F" reorganization, the merger or consolidation of two or more existing corporations cannot. To hold otherwise would for all practical purposes erase any meaningful difference between an "A" and an "F" reorganization, upon which the applicability of Section 381(b) expressly hinges, and nullify the exception provision of that section. Indeed, before consummating the reorganization here in question the parties to the merger sought and obtained from the Internal Revenue Service a ruling to the effect that the transaction would constitute an "A" reorganization; it was not until after the new corporation had sustained substantial post-merger operating losses that the parties sought to treat the transaction as an "F" reorganization and escape the mandate of Section 381(b).

The taxpayer does not and cannot point to any authority which warrants, much less demands, reversal of the unanimous decision below. The only authority which may be considered contrary to the Tax Court's decision here is a prior unreviewed decision of the Tax Court itself (Pridemark, Inc., 42 T.C. 510, reversed on other grounds, 345 F. 2d 35 (C.A. 4th)), and that decision has been properly (and unanimously) overruled by that court's later and more thoroughly reasoned opinion in this case. As for Davant (43 T.C. 540, modified 366 F. 2d 874 (C.A. 5th), upon which taxpayer also relies, the Tax Court there held that the transaction constituted a "D" reorganization, and the Fifth Circuit's alternative holding that it also constituted an "F" reorganization was unneccessary to its decision.

Equally without merit is taxpayer's alternative contention that the merger transaction should be split up into its component parts and viewed as if only one of the three merged corporation (Stauffer California) had been reincorporated (as Stauffer New Mexico), so as to constitute "a mere change in identity, form, or place of organization" of Stauffer California alone. The record shows, as the Tax Court took pains to point out, that the merger of the three Stauffer corporations into Stauffer New Mexico was carried out contemporaneously pursuant to a unitary plan, each merger being dependent on the others. Viewed as a single integrated planned transaction, as the Tax Court properly held it should be, the arrangement constituted an "A" and not an "F" reorganization.

II

The Tax Court also correctly held that the Commissioner was not precluded from determining deficiencies against Stauffer California for its taxable years ending prior to the merger (fiscal years 1958 and 1959) by reason of having made a "quickie" refund of its taxes for those years to Stauffer New Mexico, based on the erroneous carryback of Stauffer New Mexico's post-merger operating loss against the pre-merger income of Stauffer California. The refund was claimed by and made to Stauffer New Mexico, successor to Stauffer California, under the "tentative carryback adjustment" provisions of Code Section 6411. The Tax Court having correctly held that the merger did not qualify as an "F" reorganization and that therefore Section 381(b) prohibited the carryback (Point I, supra), it was likewise correct in holding that the tentative refund resulted in deficiencies in Stauffer California's pre-merger income taxes under Code Section 6211, for which Stauffer New Mexico and its stockholder are admittedly liable.

ARGUMENT

I

THE SIMULTANEOUS MERGER OR CONSOLIDATION OF THE OLD STAUFFER COMPANIES INTO STAUFFER NEW MEXICO WAS NOT AN "F" REORGANIZATION

A. Introduction

Section 381 of the Internal Revenue Code of 1954, Appendix, infra, [3/] permits a corporation that acquires the assets of another corporation, through the tax-free liquidation of a subsidiary (Section 332) or through certain types of corporate reorganizations (Section 368(a)(1), Appendix, infra), to "succeed to" various tax and accounting attributes of "the distributor or transferor corporation." It also imposes limitations and conditions which concern both the transferor corporation and the acquiring corporation. Two inter-related limitations are that the taxable year of the transferor corporation must end on the date of the transfer (Section 381(b)(1)), which means that the transferor corporation is to file a closing tax return at that time notwithstanding that its usual taxable year would not have ended at that time (Section 1.381(b)-1(c), Treasury Regulations on Income Tax (1954 Code), Appendix, infra); [4/] and the acquiring corporation may not carry back a post-reorganization net operating loss "to a taxable year

3/ Section references hereafter are to those of the Internal Revenue Code of 1954, unless otherwise indicated.

4/ References to Treasury Regulations hereafter are to those promulgated under the 1954 Code.

of the * * * transferor corporation." (Section 381(b)(3)). These restrictions do not apply, however, if the reorganization is one described in Section 368(a)(1)(F)--"a mere change in identity, form, or place of organization, however effected."

Petitioner claims that the merger or consolidation[5] of the old Stauffer companies into Stauffer New Mexico was an "F" reorganization and thus falls within the exception to Section 381(b). Petitioner's basic position (Br. 31-33) is that, since continuity of ownership and business is the touchstone of the "F" reorganization, that twofold requirement was fully met because the business of each of the old companies was continued in the new company, the stock of which was owned by the same sole shareholder as the predecessor companies. However, continuity of ownership and business enterprise is, in the general sense in which petitioner uses it, true of every tax-free reorganization defined by Section 368(a)(1). Subdivisions (A) through (D), coupled with Section 354, permit various amalgamating reorganizations in which multiple corporate enterprises may be combined into one corporation. Subdivision (D) and Section 355 permit a divisive reorganization such as a "spin-off," where "a part of the assets of a corporation is transferred to a new corporation and the stock of the transferee is distributed to the shareholders of the transferor."

5/ Technically, what occurred here was a consolidation. "In a merger, one corporation absorbs the corporate enterprise of another corporation," while "Consolidations typically involve the combination of two or more corporations into a newly created entity, with the old corporations going out of existence." Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Second ed.), p. 516.

See Commissioner v. Baan, 382 F. 2d 485, 491 (C.A. 9th), pending in the Supreme Court on grant of certiorari (October, 1967 Term, No. 781). Subdivision (E) permits a recapitalization, i.e., the "reshuffling of a capital structure, within the framework of an existing corporation." Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202. There is complete continuity of business enterprise in each of these reorganizations in that all business assets remain in corporate solution. What petitioner's argument is reduced to, then, is that the sole criterion of an "F" reorganization is identity of ownership; that an amalgamating or divisive reorganization is a "mere change in identity, form, or place of organization" if the shareholders of the new corporation are the same as the old.[6/] This has been rejected by the Court of Claims as to a divisive reorganization in Columbia Gas of Maryland, Inc. v. United States, 366 F. 2d 991 (100 percent continuity of ownership in the resulting two corporations). Similarly, the converse situation here, in which identically owned

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6/ Petitioner (Br. 26-28, 35-36) cites decisions such as Casco Products Corp. v. Commissioner, 49 T.C. 32, involving the reorganization of a single corporate enterprise in which redemption of a 9 percent stock interest was effectuated through a merger. The question there was whether adequate shareholder continuity of interest was maintained to qualify the merger transaction as an "F" reorganization, a question which the court deemed it unnecessary to reach on the theory that the merger and the stock redemption were functionally unrelated. See, also, Reef Corp. v. Commissioner, 368 F. 2d 125 (C.A. 5th), certiorari denied, 386 U.S. 1018, and Rev. Rul. 61-156, 1961-2 Cum. Bull. 62; compare Gallagher v. Commissioner, 39 T.C. 144, and Cabot Corp. v. United States, 220 F. Supp. 261 (Mass.), affirmed per curiam, 326 F. 2d 753 (C.A. 1st). The shareholder continuity of interest requirements for a Section 368(a)(1)(F) reorganization have been in litigation, and their precise outlines have not been determined, but these cases have no bearing on the issue here.

separate corporate enterprises are consolidated into a new corporation, requires the same result.

The Tax Court unanimously concluded that such an amalgamation is not a "mere change" in form or identity within the meaning of the "F" provision. Cf. Libson Shops, Inc. v. Koehler, 353 U.S. 382, 387-388.[7/] So doing, the court properly departed from its prior decision in Pridemark, Inc. v. Commissioner, 42 T.C. 510, reversed, 345 F. 2d 35 (C.A. 4th), and refused to follow an alternative holding in Davant v. Commissioner, 366 F. 2d 874, 884 (C.A. 5th), certiorari denied, 386 U.S. 1022. Although the Internal Revenue Service has previously taken the position that a merger of several enterprises could be an "F" reorganization, that position was reconsidered and rejected in light of its history and the provisions of the 1954 Code. The Commissioner therefore did not maintain that the merger of brother-sister corporations in Davant was an "F" reorganization on appeal to the Fifth Circuit, but argued only that it was a nondivisive "D" reorganization. The Fifth Circuit nevertheless held that the transaction was both an "F" and a "D" reorganization.[8/] As Judge Raum's opinion here points out (I-R. 232), the Solicitor General opposed certiorari in Davant on the ground that the transaction was a "D" reorganization and did not argue

7/ The Supreme Court specifically approved Newmarket Manufacturing Co. v. United States, 233 F. 2d 493, 497 (C.A. 1st), which held under the 1939 Code that after reincorporation of a single enterprise in another state a carryback was permissible because it was the same in all respects as its predecessor except for the change in corporate domicile. The Supreme Court pointed out that the difference between amalgamating separately operated and taxed enterprises and reincorporating a single corporate enterprise "is not merely a matter of form 353 U.S., p. 388.

8/ In Davant the Tax Court held (43 T.C. 540) that the transaction was a "D" (not an "F") reorganization. The Fifth Circuit's holding that it was also an "F" reorganization was unnecessary to its decision

the applicability of Section 368(a)(1)(F). We believe that the Tax Court's unanimous decision in this case is unmistakably correct and note that it has been followed in Associated Machine v. Commissioner, 48 T.C. 318, pending on appeal to this Court (No. 22304).

B. The scheme of the reorganization provisions, and the language and history of Section 368 (a)(1)(F), indicate that the "F" provision is limited to formalistic changes in a single corporate enterprise

The scheme of Section 368(a)(1) suggests a descending order of significance, with subdivision (F) as the least consequential of any reorganization. Subdivisions (A) through (D), as noted, involve business combinations and divisions. Subdivision (E), the

structure of a single corporate enterprise. The "F" provision, like the "E", does not describe any particular type of inter-corporate transaction -- such as a statutory merger or consolidation -- but simply indicates the result that may be accomplished "however effected." That result is the very limited one of "a mere change in identity, form, or place or organization." Considered in its context, that language simply means a reincorporation (a new charter) in the same or in another state and no more. See Berghash v. Commissioner, 43 T.C. 743, 752, affirmed, 361 F. 2d 257 (C.A. 2d); cf. Newmarket Manufacturing Co. v. United States, 233 F. 2d 493, 497 (C.A. 1st). To be sure, the other categories of reorganizations are in a sense concerned with changes in identity or form, but they are not "mere" changes; and to give

the "F" provision a broad reading would be to engulf other types of reorganizations, such as the divisive "D", without assimilating their restrictions (see the highly articulated Section 355 and this Court's opinion in Commissioner v. Baan, supra). In other words, subdivisions (E) and (F) are similar in that they do not describe a transaction between corporations, but relate to an intracorporate transaction which results in a change in either the capital or the corporate structure. Thus, the "E" and "F" provisions are said to apply to "'internal' readjustments in the structure of a single corporate enterprise." Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Second ed.), p. 507.

The historical setting in which Congress re-enacted the "F" provision into the 1954 Code confirms that understanding of its limited reach. The provision was derived without substantial change, from the Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 202(c). (See Judge Raum's opinion (I-R. 224).) In the period before adoption of the 1954 Code, it was applied where there was a reincorporation of a single corporate enterprise. 9/ E.g., San Joaquin Fruit & Inv. Co. v. Commissioner, 77 F. 2d 723, 724-725 (C.A. 9th), reversed on other grounds, 297 U.S. 496; Ahles Realty Corp. v. Commissioner, 71 F. 2d 150 (C.A. 2d), certiorari denied, 293 U.S. 611; George Whittel & Co. v. Commissioner, 34 B.T.A. 1070. In 1954, the House of Representatives recommended its

9/ Certain of these cases were decided under the Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 203(h)(1)(D), when the "mere change" provision was the "D" reorganization. As additions were made to the reorganization provisions, it became the "E" (see Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202-203) and finally the "F" in the present Code.

repeal because the minor alterations it permitted could be accomplished through other types of reorganizations.[10] See Bittker & Eustice, supra, p. 548. Nonetheless, it apparently was retained "at the request of the tax bar, representatives of which noted that subparagraph (F) clearly covered reincorporations of all of a corporation's assets in another state or in the same state after expiration of a charter -- transactions which might not meet the other definitions of a reorganization."[11] Columbia Gas of Maryland, Inc. v. United States, 366 F. 2d 991, 994, fn. 3 (Ct. Cl.); see 1 Senate Hearings before the Committee on Finance on the Internal Revenue Code of 1954, 83d Cong., 2d Sess., pp. 403, 539. When the present Code was enacted, it had never been thought that the "F"

10/ The "F" reorganization is generally accomplished by one of the other forms of reorganization, since no particular steps are indicated by the statute. For example, existing corporation X can merge into newly formed corporation Y through a statutory merger under Section 368(a)(1)(A) or a transfer of all its assets under Sections 368(a)(1)(D) and 354(b). Since Y started out as a shell and on the reorganization acquired all the characteristics of X, the only result is a change in the identity, form, or place of organization of X. However, the fact that a transaction which takes the form of an "A", or non-divisive "D", reorganization can amount to merely an "F" has led to some of the confusion regarding the scope of subdivision (F). The confusion results from assuming that if an "A" can be an "F", every "F" is an "A". But, of course, a true "A" -- that is, an amalgamation of separate corporate enterprises -- is not the absorption of a single corporate enterprise into a new shell and is therefore not an "F".

11/ The fears of the tax bar may have been to some extent justified because, under the law prior to the "F" provision, an exchange of stock pursuant to the reincorporation of General Motors (changing its place of organization from New Jersey to Delaware) was held to be taxable. Marr v. United States, 268 U.S. 536.

reorganization could involve multiple corporate enterprises--either the amalgamation of separately operated corporate enterprises or the division of one corporation into two or more entities. And the very narrow scope of the "F" provision was made clear in the sections of the 1954 Code which make reference to it.

C. <u>Section 381 and its history demonstrate that (1) an "F" reorganization does not include more than a single corporate enterprise and (2) the survivor of a consolidation (here Stauffer New Mexico) may not carry back a net operating loss to a taxable year of any of its predecessors</u>

1. Section 381(b) creates a set of mechanical rules requiring the closing of the taxable year of the transferor corporation on a tax-free reorganization (and the distributor corporation on a tax-free liquidation), and denying the acquiring corporation a carry-back to any pre-acquisition taxable year of the transferor (or distributor). Thus, in any reorganization there can be but one acquiring corporation (see Treasury Regulations, Section 1.381 (a)-1(2)(i), Appendix, infra), and that corporation alone survives as the taxpayer. If, for example, X, Y, and Z corporations consolidate into new corporation S (as in the present case), S is the acquiring corporation and will succeed to its predecessors' tax attributes (such as net operating losses) for prospective application under Section 381(c); S will not be entitled to carry back any post-consolidation net operating losses to any pre-consolidation year of its constituents. Section 381(b)(3); Treasury Regulations, Section 1.381(c)(1-1(b), Example (2), Appendix, <u>infra</u>. On a

statutory merger, in which case S would have been conducting its own business prior to the reorganization (see footnote 5, supra), Section 381(b) would not preclude S from carrying back to its own pre-reorganization taxable years a net operating loss arising after the merger.[12] Treasury Regulations, Section 1.381(c)(1)-1(b), Example (1), Appendix, infra. Thus, the application of Section 381(b) and (c) hinges entirely on the acquiring corporation: It succeeds only prospectively to the tax attributes of the corporations which it acquires and fully retains its own tax attributes, if any.

Considered in this light, it can be seen why Congress excepted the "F" reorganization from Section 381(b). The reincorporation of a single enterprise in a different state would have required a closing return and loss of a possible carryback when, apart from the change of domicile, the resulting corporation would be the same taxpayer as its predecessor. So the Treasury Regulations, Section 1.381(b)-1(a)(2), Appendix, infra, provide that in an "F" reorganization "the acquiring corporation shall be treated * * * just as the transferor corporation would have been treated if there

12/ Note, however, that a net operating loss of X or Y or Z to which S succeeded as a result of the reorganization could not be carried back to any prior taxable year of S, but could only be carried forward. Section 381(c)(a)(1)(A).

had been no reorganization." Judge Raum stated (I-R. 221), "The underlying theory of * * * [this provision] quite plainly is that there is such a complete identity between the pre- and post-reorganization enterprises in an 'F' reorganization that the acquiring corporation is to be treated exactly as the transferor corporation would have been treated in the absence of any reorganization."

The Treasury Regulations (Sections 1.381(b)-1(a)(2) and 1.381(c)(1)-1(b), Examples 1 and 2) which explain the operation of Section 381(b) in connection with a consolidation, merger, and "F" reorganization are directly traceable to the report of the Senate Finance Committee, which did the final drafting of Section 381. Three examples are given in the report which establish that the Tax Court correctly applied Section 381 in this case (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 276 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4914-4915):

> Paragraph (3) of subsection (b) provides that an acquiring corporation to which property is distributed or transferred in a corporate transaction described in paragraphs (1) and (2) of subsection (a) (except a reorganization described in subparagraph (F) of section 368(a)(1)) is not entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation. For example, [1] assume corporations X and Y transfer on December 31, 1954, all their property to Z in a transaction described in subparagraph (A) of section 368(a)(1). <u>If Z has a net operating loss in 1955, such loss cannot be carried back to a taxable year of X or Y.</u> Or, [2] assume corporation X <u>merges</u> into corporation Y on December 31, 1954, <u>in a statutory merger</u> with

> Y's charter continuing after the merger. If Y has a net operating loss in 1955, such loss cannot be carried back to a taxable year of X but shall be a carryback to a taxable year of Y. [3] If, however, corporation X, in a reorganization described in subparagraph (F) of section 368(a)(1), merely changes its identity, form or place of organization, the resulting corporation is entitled to carry back its net operating loss to a taxable year of X prior to the reorganization. [Emphasis added.]

Example 3 in the excerpt deals with the "F" reorganization situation in regard to a single corporation; and example 2 above deals with a merger of two existing corporations in which one retains its charter and, for that reason, its own tax attributes. Example 1 concerns the situation in this case -- consolidation of existing corporations into a new corporation -- and clearly shows that there is to be no carryback to any taxable years of the constituent companies. Insofar as Section 381 deals with carrybacks, it is apparent that Congress infused into the 1954 Code the single business enterprise theory that was adopted by the Supreme Court in Libson Shops, supra, and the First Circuit in Newmarket Manufacturing Co. v. United States, 233 F. 2d 493. 13/

13/ Those decisions, of course, came down under the 1939 Code, but each made reference to the 1954 Code provisions that had already been enacted. Newmarket noted that Section 381(b) would have permitted the carryback in circumstances like those before it (the reincorporation of a single enterprise in another state). 233 F. 2d, p. 493. The Supreme Court in Libson Shops adopted that same rationale, making special reference to the Newmarket case. It cannot be assumed that these decisions failed to take account of the relevant aspects of the 1954 Code.

In short, the operation of Section 381, reinforced by the plainest legislative declarations and the Treasury Regulations, should be decisive of the principal issue here. But there are, as we will show, even further indications that Congress intended and contemplated that the "F" provision would retain its traditionally limited application to a single corporate enterprise.

2. One of the fundamental principles of Section 381 is that the acquiring corporation shall take into account the tax attributes of the transferor corporation only prospectively. Section 381(c)(1)(A) requires that the net operating losses of the transferor corporation, to which the acquiring corporation succeeds, be carried forward starting with "the first taxable year ending after the date of * * * transfer." Stated another way, the acquiring corporation may not carry back the transferor's net operating loss to any of its pre-reorganization taxable years. Read in this way, it is evident that Section 381(c)(1)(A) is a necessary counterpart to Section 381(b), which precludes a carryback of the acquiring corporation's net operating loss to a pre-reorganization taxable year of the transferor corporation. In combination, Sections 381(b) and 381(c)(1)(A) prevent the tax attributes of the acquiring corporation to be used retrospectively to change tax results of the pre-reorganization years of the transferor corporation (when it constituted a separately taxed entity), and similarly the tax attributes of the transferor corporation may not be used to alter the pre-reorganization tax results of the acquiring corporation.

Applying petitioner's notion that a reorganization which combines two or more corporate enterprises can be within the "F" provision, leads to the following anomaly: The highly restrictive Section 381(b), which denies certain advantages to all except the "F" reorganization, would not prevent a carryback of the acquiring corporation's net operating loss to a taxable year of the transferor, whereas Section 381(c)(1)(A) (which does not except the "F" reorganization) would prevent a carryback of the net operating loss of the transferor to a pre-reorganization taxable year of the acquiring corporation even in the case of "a mere change in identity, form, or place of organization" (an "F" reorganization). Plainly, if Congress had intended that the "F" provision encompass more than a single enterprise it logically would have provided the same exception in Section 381(c)(1)(A) as it provided in Section 381(b). However, the exception for the "F" reorganization in Section 381(b), again we submit, was designed to permit a carryback to a pre-reorganization year of the transferor only when the acquiring corporation is the same taxpayer as the transferor corporation and not when the acquiring corporation is an amalgamation of separately operated and taxed enterprises.

3. An "F" reorganization involving more than a single enterprise would make Section 381(b)(1) unworkable and would run counter to the most elementary principles of taxation. Assume that two of the old Stauffer companies had filed returns for different fiscal-year periods, and that the third company filed its return on a calendar year basis. Assume further that they consolidated into

Stauffer New Mexico (as here) before the end of each of their normal taxable years. Under petitioner's theory of the "F" exception to Section 381(b)(1), the taxable years of the old companies would not end. These questions arise: First, would Stauffer New Mexico have to file three returns -- one for each predecessor as its taxable year came to an end? Second, insofar as the three old companies were separately operated during the parts of their several taxable years prior to the merger, may their operations in that period be combined in a single return filed by Stauffer New Mexico? Third, assuming Stauffer New Mexico could file a single return, would it report on a fiscal year basis or a calendar year basis? If Stauffer New Mexico adopted a calendar year basis for filing its return, the effect would be either to lengthen or to shorten the normal accounting period of at least the two predecessors that had previously filed on a fiscal basis. The rationale behind Section 381(b)(1) is to eliminate these problems by one general rule requiring the transferor corporations to end their taxable years at the date of transfer and thus report their separate incomes and expenses as separate corporate taxpayers to the extent that they were separately operated for any period prior to the reorganization.

In this case, it was no more than pure happenstance that the old Stauffer companies filed returns using the same fiscal period, so that the questions that would normally arise were not immediately apparent. Nevertheless, the three old Stauffer companies filed no returns for the eight-month period when they were operated as separate taxpayers prior to their absorption by Stauffer New Mexico.

While it is true that Stauffer New Mexico filed a return at the end of the fiscal period which included these pre-reorganization operations of the old companies, the return was one "combining the operations of all the companies for the entire fiscal year." (I-R. 193.) Can the eight-month period of individual accountability of the old companies be ignored and the reorganization be given effect as if it had occurred at the beginning of the fiscal period? Section 381 permits succession to the tax attributes of predecessors, but it does not permit the surviving corporation to combine and thus revise the pre-reorganization individual accountability of the constituent companies. Apart from the filing of a consolidated return, which is not available to brother-sister corporations, it is fundamental that separate corporations must file separate returns. It is clear that Congress did not wish to undermine that rule in Section 381. Indeed, Section 381(b)(1) is indisputably designed to prevent abrogation of the usual rule.

Again, it can be seen that in excepting the "F" reorganization from Section 381(b)(1) Congress meant only to permit a single corporate enterprise to continue its regular reporting and not to permit separate corporations to combine their operations for the period prior to reorganization.

4. Section 381(a)(2) limits the carryover privilege to non-divisive "D" reorganizations (those that meet the requirements of Section 354(b)). "The section [381] does not apply * * * to divisive or other reorganizations not specified in subsection (a)." S. Rep. No. 1622, <u>supra</u>, p. 276 (3 U.S. Code Cong. & Admin.

News (1954), 4621, 4914). The "spin-off" divisive reorganization is the exact opposite of what occurred here. In its basic form it involves a distribution of all the stock of a newly-created subsidiary corporation to the shareholders of the parent corporation. See Sections 355 and 368(a)(1)(D). Hence, in that way business enterprises originally combined in a single corporation can be separated into two or more brother-sister corporations. Here, brother-sister corporations were consolidated into a single entity.

Taking the expansive view of "identity" or "form" that petitioner adopts, the division of a single corporation into brother-sister corporations cannot rationally be distinguished, for purposes of applying Section 381(b), from the amalgamation of brother-sister corporations into a single corporation.

It therefore stands to reason that, if shareholder continuity were the sole and sufficient test of an "F" reorganization, as petitioner maintains, the spin-off reorganization would come under Section 381(b) through qualification as an "F" reorganization notwithstanding Congress' intended exclusion.[14/] Neither the spin-off nor the amalgamation of brother-sister corporations is a "mere" change in the tax or business world. The separation or division of a single corporate enterprise into two or three corporations further limits the liability of their common shareholders. Each corporation files its own tax return, and each obtains a surtax

14/ There is also the problem that from 1934 to 1951, Congress did away with a provision that permitted the spin-off reorganization to be classed as a tax-free reorganization. Commissioner v. Baan, supra, p. 491. If the spin-off could have qualified as an "F" reorganization, Congress' purpose in repealing the provision would have been frustrated.

exemption under Section 11(d). From the opposite side of the coin, the amalgamation of three brother-sister corporations may increase efficiency or make credit more easily available because of the larger pool of assets in a single unit. And, of course, it will require the filing of one tax return and only one surtax exemption in lieu of three returns and three exemptions. If these represent "mere" changes of identity or form for purposes of the "F" provision, then every tax-free reorganization defined by Section 368(a)(1) is an "F" reorganization. 15/

A fair reading of Section 381, its legislative history, and the "F" provision itself requires the conclusion that an amalgamation of three separate corporate enterprises cannot be an "F" reorganization. The Fifth Circuit's alternative holding to the contrary, in Davant, was in an entirely different context than this case. Section 381 was not before the Fifth Circuit and, unfortunately, the legislative evidence presented to the Tax Court and this Court was not presented to it. We consequently urge this Court not to follow the alternative ruling in Davant. For, as Judge Raum stated (R. 230), "The Code

15/ In Addition to the irreconcilable problems relating directly to Section 381 that acceptance of petitioner's theory would create, Judge Raum's opinion (R. 228-229) notes the difficulties it would raise as to the complex Section 1244 (losses on the stock of a small business corporation). Section 1244(d)(2) is headed "Recapitalizations, changes in name, etc." and provides a special rule for an "F" reorganization -- obviously because it involves no more than a change in name or a reincorporation.

As also noted in the opinion below (R. 44), petitioner's theory of an "F" reorganization would create additional problems regarding treatment of the capital and surplus (or deficit) accounts of the old corporations.

is an extraordinarily complex and sensitive instrument, and we should be careful not to give an interpretation to one provision that would generate unintended difficulties in respect of other provisions, unless such interpretation is clearly called for by the statute itself. In the situation before us we can find no such command in the statute requiring the fusion of these three corporations to be treated as a 'mere change in identity, form, or place of organization.' To the contrary, the indications point the other way." After almost fifty years in which the "F" provision lay dormant and after Congress employed it in the 1954 Code in reliance on its highly restricted compass, it is too late in the day to enlarge it beyond its historic limits.

D. There was no single "F" reorganization of Stauffer California into Stauffer New Mexico

Petitioner maintains (Br. 10, 31-36, 49-51) that the merger or consolidation of all the companies into Stauffer New Mexico was either an "F" reorganization or three separate "F" reorganizations. These "alternative" contentions actually represent one argument stated in two ways, and for the reasons already outlined that argument is unsound.

It appears to us that petitioner places major emphasis on the contention that the absorption of Stauffer California by Stauffer New Mexico was alone an "F" reorganization. Petitioner's preliminary statement (Br. 18) presents four hypothetical situations, other than the one in issue, in which Stauffer California might have

been entitled to a carryback. Apart from the second illustration, involving a pure "F" reorganization in which Stauffer California by itself would have changed its place of organization to New Mexico, each of the other illustrations is dependent on a merger of Stauffer New York and Stauffer Illinois into Stauffer California[16/] in which Stauffer California -- as the acquiring corporation -- would fully retain its own corporate and tax attributes. These hypothetical situations do not support petitioner's position; indeed, they bring out the fact that the "F" reorganization claim is not its real claim here. No carryback is permissible because Stauffer California was not the acquiring corporation under Section 381; Stauffer New Mexico was the acquiring corporation, and it happened not to have any pre-existing tax attributes that would survive the reorganization. It therefore becomes evident that petitioner, in asking that Stauffer California's absorption into Stauffer New Mexico be segregated and treated as an "F" reorganization, is truly requesting a reformation of the entire transaction so that Stauffer California can take on the identity of Stauffer New Mexico and become the acquiring corporation.[17/]

16/ In situation one, the Illinois and New York companies merge into Stauffer California; in situation three, the same merger occurs and then Stauffer California changes its place of organization; and in situation four, Stauffer California first changes its place of organization to New Mexico and then the other two companies merge into it.

17/ Furthermore, it is axiomatic that tax consequences flow from what the taxpayer does, not from what it might have done. E.g. Founders General Co. v. Hoey, 300 U.S. 268, 275; Television Industries, Inc. v. Commissioner, 284 F. 2d 322, 325 (C.A. 2d); Montana Power Co. v. United States, 232 F. 2d 541, 543 (C.A. 3d).

The excerpt from the legislative history of Section 381 (quoted, supra) shows that Congress envisaged precisely what occurred here. The Senate Finance Committee Report explicitly called attention to a transaction consolidating separate corporations and expressly stated that a carryback to any pre-reorganization taxable years of the constituent companies would not be permissible. Section 381(b) simply establishes a uniform rule that gives rise both to benefits and to burdens. 18/ For example, in this case, the old Stauffer companies were required to file closing returns on the date of the transfer, but were together entitled to three surtax exemptions. Stauffer New Mexico, in starting as a new taxpayer, could have adopted an accounting period different from any of its constituents. Since it, too, was entitled to a surtax exemption, and since the reorganization occurred before the end of the fiscal years of the old companies, there were a total of four surtax exemptions within the same accounting period. There are taxpayers who attempt to arrange corporate reorganizations in such

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18/ The previously quoted excerpt from the Senate Finance Committee Report also shows that in a true merger -- i.e., the absorption of the assets of one corporation (X) by another operating corporation (Y) -- the acquiring corporation (Y), its "charter" continuing after the merger, would have the right to carryback to its pre-merger taxable years a subsequently arising net operating loss. Thus, Congress fully recognized that it was creating a rule that hinged on the identity of the acquiring corporation.

a way as to increase the number of surtax exemptions, despite their giving up a carryback to pre-reorganization taxable years. See Dunlap & Associates, Inc. v. Commissioner, 47 T.C. 542. We need not speculate as to what tax considerations were in the mind of Mr. Stauffer when the old Stauffer companies were consolidated into Stauffer New Mexico, but doubtless if Stauffer New Mexico had operated profitably the four surtax exemptions would have looked much better than the possibility of a net operating loss carryback.

What is important here is that there was one transaction by which Stauffer New Mexico acquired all the assets of the old companies. No part of the whole transaction can be disengaged and accorded special consideration. Cabot Corp. v. United States, 326 F. 2d 753 (C.A. 1st), affirming per curiam, 220 F. Supp. 261 (D. Mass.).

The merger agreement, to which all four corporations were parties, specifically provided that it would not be binding or effective until approved by the shareholders of each company and the state filing requirements were met. (Ex. 7-A, paras. 8A-8F.) Stauffer New Mexico was to have capital and surplus equal to the sum of the items of the old companies on the effective date of the merger; it was to have all the property of the constituent companies upon the merger becoming effective; and the separate existence of the old companies would cease on the effective date

of the merger. (Ex. 7-A, paras. 6E-6F, 6I, 8I.) Petitioner itself points out (Br. 56) that paragraph 6E of the merger agreement defined "the effective date of the merger" as "the effective date of the last of the individual mergers." (Emphasis added.) In fact, all of the steps necessary to consummate "the merger" were carried out on October 1, 1959. (I-R. 189-190.) The Tax Court consequently found (I-R. 233-234):

> The merger agreement specifically stated that it would not be binding upon any of the constituent corporations, their officers, or stockholders until a copy of the agreement and any other certificates and documents required by law were properly filed and recorded with the proper governmental authority of all four states. Even if Stauffer California complied with the laws of its jurisdiction before Stauffer Illinois and Stauffer New York did so, a finding we cannot make on the state of this record, by the terms of the Merger Agreement there was no valid merger between any of the corporations until the laws of all of the states involved had been complied with. Thus, the three old Stauffer companies merged into Stauffer New Mexico not seriatim but simultaneously. Either all three were parties to the "F" reorganization or none were. The three mergers were interdependent. (Emphasis added.)

Moreover, what was done was also the natural means of accomplishing the stated business purposes for the reorganization. The reorganization was not intended to defer to Stuaffer California's "dominance," but to physically relocate the businesses of the three old companies in New Mexico where "it would be possible through the merger to bring all the activities of the business within a single corporate body subject to the jurisdiction of the State of New Mexico, in which state most of the assets of the business would be

located." (I-R. 188.)[19/] Although subsequent business reverses did not permit the physical relocation to New Mexico, the point is that the reorganization was not merely intended to change the domicile of any one corporation. It was intended to change the domicile of all of the companies by combining them all into a "single corporate body." In addition, Judge Raum found (I-R. 217-218):

> Before consummating the reorganization in question the parties had sought and obtained from the Internal Revenue Service a ruling to the effect that the transaction would result in a tax-free reorganization as a "statutory merger or consolidation" within the meaning of subparagraph A of section 368(a)(1). It was then expected that each of the constituent companies would file closing returns, and indeed, as late as December 15, 1959, an application was filed on behalf of each of the three old Stauffer companies for an extension of time for filing returns for the period February 1 - September 30, 1959. * * * It was only later, when it became clearly apparent that the new company had sustained substantial losses during the four-month period, October 1, 1959 - January 31, 1960, that it was determined to file a single return for the full fiscal year February 1, 1959 - January 31, 1960 in the name of the new company and to include therein the profitable operations of the three old Stauffer companies for the first eight months against which the losses of the last four months were applied. In order to justify that course of action, as well as the failure to file closing returns for the three old Stauffer companies, the position was taken that the merger of the three old companies into Stauffer New Mexico was an "F" reorganization.

19/ Mr. Stauffer was describing the plan to the board of directors of Stauffer California, which was identical for all of the Stauffer companies except Stauffer New York which had one additional inactive director. (I-R. 187.) Mr. Stauffer's reference to the "business" means the three old Stauffer companies since he is speaking of a merger into a "single" corporate body.

Thus, before and even after the reorganization there was no intention to retain the tax identity of Stauffer California alone, assuming that such a mere intention unconfirmed by the nature of the reorganization itself is material. Furthermore, in filing a single return covering the pre-merger operations of the old companies, it was surely recognized that the consolidation of the three companies was one transaction that had to qualify as an "F" reorganization in toto or not at all.[20]

In the Tax Court (I-R. 232) and before this Court, petitioner (Br. 42-44) places heavy reliance on Rev. Rul. 58-422, 1958-2 Cum. Bull. 145. There (p. 146), "a corporation desired, for valid business reasons, to reincorporate in a state other than the state of its incorporation and to acquire and operate directly the assets and businesses of its two wholly-owned subsidiaries." Although the transactions were carried out simultaneously in the form of an "A" reorganization, i.e., the parent and subsidiaries merged

20/ Petitioner (Br. 28-30) discusses Dunlap & Associates, Inc. v. Commissioner, 47 T.C. 542, in which a corporation changed its domicile from New York to Delaware (by merging into a newly formed Delaware corporation) and simultaneously made a tender offer to acquire a minority interest in its subsidiaries in exchange for its own stock. The sole question was whether the issuance of stock on the tender offer sufficiently shifted the ownership to defeat an "F" reorganization. The Tax Court held that there was an "F" reorganization because the tender offer and the reorganization were separate transactions (id. at 551): "there was no assurance, at the time of the merger [i.e., the reincorporation in Delaware], that such minority interest would accept the offers. Nor was there any provision in the merger agreements that the transfer of the New York corporation's assets to petitioner would be undone if the minority stockholders were not responsive to the offers." (Emphasis added.) The Dunlap case, patently, bears no kinship to the present case. There, the issuance of stock on the tender offer was not an integral part of the reorganization.

into a newly-formed corporation, the Service ruled that there was an "F" reorganization as to the parent company and a tax-free liquidation of the subsidiaries under Section 332. Judge Raum concluded (I-R. 232-233), that that situation is distinguishable from this case "since the subsidiaries or their businesses were always under the same corporate umbrella of the parent, both before and after the reorganization." Indeed, Section 332 (complete liquidation of a subsidiary) provides at the end of its subsection (b) that "a transfer of property of * * * [the subsidiary] to the taxpayer shall not be considered as not constituting a distribution * * * in complete cancellation or redemption of all the stock of * * * [the subsidiary], merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by * * * [the subsidiary] of property, <u>not attributable to shares owned by the taxpayer</u>, on an exchange described in Section 361 [tax-free exchanges between parties to a reorganization], and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in Section 354 [tax-free exchanges of stock and securities of corporations which are parties to a reorganization], <u>of the shares not owned by the taxpayer</u>." (Emphasis added.) What this passage means is that, if corporation A's subsidiary B transfers its property to corporation X in a tax-free reorganization in which B's shares are cancelled, the transaction is nonetheless to be treated as the complete liquidation of a subsidiary under

Section 332 and not a corporate reorganization. See Treasury Regulations, Section 1.332-2(d), (e).

It is understandable, then, that Rev. Rul. 58-422, supra, p. 146, holds that "the liquidation of the two subsidiaries in pursuance of the merger agreement are liquidations to which Section 332 applies." The ruling further explains (p. 146):

> In the instant case, the fact that the subsidiaries of the former parent were liquidated at the same time that the said parent reincorporated in a different state did not constitute a change in the stockholders or assets of the merged corporation. The stockholders of the former parent had the same equity in the surviving corporation that they had in the three old corporations, inasmuch as all of the assets of the three transferor corporations were held by the surviving corporation. In this connection, had the subsidiaries liquidated under the nontaxable provisions of section 332 of the Code before the merger and, subsequently, the parent reincorporated in a different state, the latter transaction would have been considered a reorganization coming within the provisions of section 368(a)(1)(F) of the Code. The fact that the two transactions were consummated simultaneously does not change the above conclusions. (Emphasis added.)

What the ruling says is this: First, the liquidation of the two subsidiaries is a separate transaction (under Section 332) from the reorganization of the parent. Second, since there were two transactions the mere fact that they were consummated simultaneously in time does not alter their separate individual character. Third, a comparison with a situation in which the two transactions are separated in time indicates that the liquidation of the subsidiaries

does not destroy a subsequent reincorporation of the parent. Fourth, there is no reason why the liquidation should do so when it is consummated simultaneously with an "F" reorganization.[21]

In contrast, the present case involves the amalgamation of brother-sister corporations into a newly formed corporation--a transaction which in its entirety falls within Section 368 (a)(1)(A); it was executed in the same manner in which amalgamating "A" reorganizations are usually consummated; there was a unitary agreement in which each step was made legally inter-dependent upon the other; and there was no intention evidenced, subjectively or objectively, that Stauffer California alone should undergo an "F" reorganization and retain its tax identity.

Perhaps the best way to look at this case is to turn it around and suppose that the Commissioner were maintaining that Stauffer California had merged into Stauffer New Mexico under the "F" provision, and therefore Stauffer California should not file a closing return and Stauffer New Mexico should not thereby obtain an additional surtax exemption for the fiscal period. Would the Commissioner have even an arguable case? Petitioner would claim that the amalgamation of the three old Stauffer

21/ It is significant that the ruling did not hold that the tax-free liquidation of the subsidiaries was an "F" reorganization, even though they had a closer relationship with the parent than the three brother-sister corporations had inter se in this case. Also, under Section 381(a)(1) and (b), the liquidated subsidiaries would be required to file closing returns and no carryback would be allowed to their taxable years.

companies into Stauffer New Mexico was an "A" reorganization and no part of it was an "F" -- and petitioner would be clearly right.

II

THE ERRONEOUS CARRYBACK TO STAUFFER CALIFORNIA'S TAXABLE YEARS RESULTED IN A DEFICIENCY IN ITS TAX LIABILITY FOR WHICH MR. STAUFFER BECAME LIABLE AS AN ADMITTED TRANSFEREE

The issue in this phase is whether the "quickie" refund of Stauffer California's pre-reorganization taxes, based on the erroneous carryback of Stauffer New Mexico's losses, resulted in a deficiency in Stauffer California's tax liability. 22/ See Section 6211, Appendix, infra. If such a deficiency did arise, Mr. Stauffer's (hence petitioner's) liability as ultimate transferee is admitted. (I-R. 183.) Petitioner's argument is that no deficiency arose in Stauffer California's taxes because (Br. 65) the rebate was made to Stauffer New Mexico, "held to be an entirely different taxpayer than Stauffer California." But petitioner agrees (Br. 65-66,67) as it must with the Tax Court's holding (I-R. 241-242) that Stauffer New Mexico as the successor of Stauffer California through an "A" reorganization had standing to claim a refund of Stauffer California's taxes. See Rev. Rul. 54-17, 1954-1 Cum. Bull. 160. Petitioner diverges (Br. 67) from the Tax Court solely on the basis that (a) Stauffer New Mexico filed the refund claim in its own name and not in the name of, or on behalf of Stauffer California and (b) Stauffer New Mexico failed to

22/ Any deficiencies as a result of the failure of the three old Stauffer companies to file closing returns for the pre-reorganization portion of their fiscal periods are not involved in this aspect of the case; petitioner's contentions are limited to the carryback.

file proper evidence establishing its successor status, all of which were requirements of Rev. Rul. 54-17, supra.

Petitioner's position is utterly without substance. Its failure to meet the formal requirements of Rev. Rul. 54-17, supra, would have been grounds for the Commissioner to reject the refund claim, which he could waive by making a refund. See Angelus Milling Co. v. Commissioner, 325 U.S. 293. It was there asserted that the Commissioner had waived any objection to errors in a refund claim (similar to those in this case) because he had considered the claim on its merits. Although in Angellus it was held that there had been no waiver, Justice Frankfurter, writing for the Court, stated (325 U.S., p. 297):

> If the Commissioner chooses not to stand on his own formal or detailed requirements, it would be making an empty abstraction, and not a practical safeguard, of a regulation to allow the Commissioner to invoke technical objections after he has investigated the merits of a claim and taken action upon it.

Rev. Rul. 54-17, supra, creates procedural requirements for the benefit of the Government that facilitate the administrative refund process, and it is incredible that those requirements can be raised against the Government when a rebate has been made to the appropriate party. Stauffer New Mexico, as the successor of Stauffer California, was procedurally entitled to assert and receive a "quickie"(tentative) refund of Stauffer California's taxes. And this petitioner affirms. Nor does petitioner dispute that the refund claim related to Stauffer California's taxes. It follows that since the basis of the refund

assets of Stauffer California and it assumed and agreed to pay all federal taxes "due and payable by * * * [Stauffer California] for the taxable year (or years) ended 1/31/58 and 1/31/59." (I-R. 200.) Thus, Stauffer New Mexico admitted its obligation as transferee for any deficiencies in the tax of Stauffer California for the years to which the carryback was claimed.

Mr. Stauffer's transferee liability for deficiencies in Stauffer California's taxes is also admitted.

In any event, it is not necessary for Stauffer New Mexico to be a "transferee." As Stauffer California's successor, it was liable for any deficiency in its predecessor's taxes, and such a deficiency arose on rebate of the taxes. Commissioner v. Newport Industries, Inc., 121 F. 2d 655 (C.A. 7th). Mr. Stauffer, on liquidation of Stauffer New Mexico, received its assets (and its predecessors') charged with the obligation to pay Stauffer California's tax deficiency which was also Stauffer New Mexico's obligation. Indeed, Mr. Stauffer, as trustee in liquidation of Stauffer New Mexico negotiated the refund checks totalling more than $1,750,000. (I-R. 199.) Petitioner's arguments are wholly without merit.

CONCLUSION

For the foregoing reasons, the decisions of the Tax Court should be affirmed.

Respectfully submitted,

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April, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ________________ day of ______________________, 1968.

MARTIN T. GOLDBLUM
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APPENDIX

Internal Revenue Code of 1954:

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) Deduction Allowed.--There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87-794, 76 Stat. 872] Net Operating Loss Carrybacks and Carryovers.--

(1) Years to which loss may be carried.--

(A)(i) Except as provided in clause (ii), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

* * *

(B) Except as provided in subparagraph (c), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * *

(2) Amount of carrybacks and carryovers.--Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. * * *

* * *

(c) Net operating Loss Defined.--For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

* * *

(26 U.S.C. 1964 ed., Sec. 172.)

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization.--

(1) In General.--For purposes of parts I and II and this part, the term "reorganization" means--

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

*　　　　*　　　　*

(26 U.S.C. 1964 ed., Sec. 368.)

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) General Rule.--In the case of the acquisition of assets of a corporation by another corporation--

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b) (2); or

(2) in a transfer to which section 361 (relating to nonrecognition of a gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354 (b) (1) are met), or (F) of section 368 (a) (1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) Operating Rules.--Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368 (a) (1)--

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) Items of the distributor or transferor corporation.--The items referred to in subsection (a) are:

(1) Net operating loss carryovers.--The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

* * *

(3) Capital loss carryover.--The capital loss carryover determined under section 1212, subject to the following conditions and limitations;

(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.

*   *   *

(26 U.S.C. 1964 ed., Sec. 381.)

SEC. 6211. DEFINITION OF A DEFICIENCY.

(a) In General.--For purposes of this title in the case of income, estate, and gift taxes, imposed by subtitles A and B, the term "deficiency" means the amount by which the tax imposed by subtitles A or B exceeds the excess of--

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over--

(2) the amount of rebates, as defined in subsection (b) (2), made.

(b) Rules for application of subsection (a).--For purposes of this section--

*   *   *

(2) The term "rebate" means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed by subtitles A or B was less than the excess of the amount specified in subsection (a) (1) over the rebates previously made.

*   *   *

(26 U.S.C. 1964 ed., Sec. 6211.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.381(a)-1 General rule relating to carryovers in certain corporate acquisitions.

* * *

(2) Acquiring corporation defined. (i) Only a single corporation may be an acquiring corporation for purposes of section 381 and the regulations thereunder. The corporation which acquires the assets of its subsidiary corporation in a complete liquidation to which section 381(a)(1) applies is the acquiring corporation for purposes of section 381. Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

* * *

(3) Transactions and items not covered by section 381. (i) Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

* * *

(26 C.F.R., Sec. 1.381(a)-1)

§ 1.381(b)-1 Operating rules applicable to carryovers in certain corporate acquisitions.

(a) Closing of taxable year--(1) In general. Except in the case of a reorganization qualifying under section 368(a)(1)(F), the taxable year of the distributor or transferor corporation shall end with the close of the date of distribution or transfer.

> (2) Reorganizations under section 368(a)(1)(F). In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

*   *   *

(c) Return of distributor or transferor corporation. The distributor or transferor corporation shall file an income tax return for the taxable year ending with the date of distribution or transfer described in paragraph (b) of this section. If the distributor or transferor corporation remains in existence after such date of distribution or transfer, it shall file an income tax return for the taxable year beginning on the day following the date of distribution or transfer and ending with the date on which the distributor or transferor corporation's taxable year would have ended if there had been no distribution or transfer.

*   *   *

(26 C.F.R., Sec. 1.381(b)-1)

§ 1.381(c)(1)-1 Net operating loss carryovers in certain corporate acquisitions.

* * *

(b) Carryback of net operating losses. A net operating loss of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the taxable income of a distributor or transferor corporation. However, a net operating loss of the acquiring corporation for any such taxable year shall be carried back in accordance with section 172(b) in computing the taxable income of the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, a net operating loss sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 172(b) in computing the taxable income of such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the taxable income of the acquiring corporation. This paragraph may be illustrated by the following examples:

Example (1). On December 31, 1954, X Corporation merged into Y Corporation in a statutory merger to which section 361 applies, and the charter of Y Corporation continued after the merger. Y Corporation sustained a net operating loss for the calendar year 1955. Y Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation but shall be carried back in computing the taxable income of Y Corporation.

Example (2). On December 31, 1954, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory consolidation to which section 361 applies. Z Corporation sustained a net operating loss for the calendar year 1955. Z Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation or Y Corporation.

Example (3). On December 31, 1954, X Corporation ceased all operations (other than liquidating activities) and transferred substantially all its properties to Y Corporation in a reorganization qualifying under section 368(a)(1)(C). Such properties comprised all of X Corporation's properties which were to be transferred pursuant to the reorganization. In

the process of liquidating its assets and winding up its affairs, X Corporation sustained a net operating loss for its taxable year beginning on January 1, 1955. This net operating loss of X Corporation shall be carried back in computing the taxable income of that corporation but may not be carried back or over in computing the taxable income of Y Corporation.

*   *   *

(26 C.F.R., Sec. 1.381(c)(1)-1)

GPO 926-100

Nos. 22277, 22277A and 22277B

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

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Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 22277A

ESTATE OF BERNARD H. STAUFFER, BONNIE H. STAUFFER, EXECUTRIX,

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vs.

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vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petitions for Review of the Decisions of the Tax Court of the United States.

PETITIONER'S REPLY BRIEF.

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PETITIONER'S REPLY BRIEF.

THE "F" REORGANIZATION ISSUE.

I.

Respondent's Brief Contains a Number of Fundamental Concessions.

Although Respondent may dispute the legal conclusions arrived at by Petitioner in her Opening Brief, Respondent concedes most of the foundational points which underlie those conclusions. The major points which Respondent concedes to be correct (either expressly or by inference) are as follows:

1. The operating loss carryback would have been undeniably available had the relevant transactions been structured in any one of various other ways.

2. The basic philosophy underlying the *Libson Shops*[1] decision, as to the purpose of the loss carryback provisions, is equally applicable under the 1939 and 1954 Codes and indicates that Stauffer New Mexico was entitled to carry back its losses.

3. The only case authorities in point, *Pridemark*[2] and *Davant,*[3] directly support Petitioner's contentions herein.

4. Other than in the cases at bar and *Associated Machine,* which is also on appeal to this Court, Respondent has consistently advocated a broad interpretation of the "F" reorganization provisions.

5. Rev. Rul. 58-422,[4] like the cases at bar, involved an amalgamation of three corporations by means of a single statutory merger, and yet Respondent ruled therein that the merger involved an "F" reorganization.

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[1]*Libson Shops, Inc. v. Koehler* (1957) 353 U.S. 382.

[2]*Pridemark, Inc.* (1964) 42 T.C. 510, modified on other grounds (4th Cir. 1965), 345 F.2d 35.

[3]*Davant v. Commissioner,* sub. nom. *South Texas Rice Warehouse Co.,* (1965) 43 T.C. 540, aff'd. in part and rev'd. in part (5th Cir. 1966) 366 F.2d 874, cert. den. 386 U.S. 1022.

[4]1958-2 C.B. 145.

II.

Respondent Cannot Distinguish Pridemark and Davant, or Rev. Rul. 58-422.

In attempting to avoid the impact of these fundamental concessions, Respondent asserts that he was in error in arguing in the *Pridemark* and *Davant* cases that an "F" reorganization had occurred and that the Courts were misled into accepting his arguments. We submit, however, that since the arguments advanced by the taxpayers in *Pridemark* and *Davant* are substantially the same as those advanced by Respondent herein,[5] the courts deciding *Pridemark* and *Davant* had adequate opportunity to consider fully and then reject the arguments Respondent presses herein.

Respondent then argues, with respect to Rev. Rul. 58-422, *supra*, that although an amalgamation of a parent and its two subsidiaries into a new corporation constitutes an "F" reorganization as to the parent and the new corporation, an amalgamation of three brother-sister corporations is in some way a different kind of amalgamation and therefore cannot qualify as an "F" reorganization as to any of the participants. The issue with respect to the meaning of Rev. Rul. 58-422 is, of course, primarily relevant to an alternative argument of Petitioner herein; namely, that the reincorporation of Stauffer California alone constitutes an "F" reorganization under the principles enunciated in Rev. Rul. 58-422. However, Respondent's arguments in attempting to distinguish Rev. Rul. 58-422 so effectively refute his own position in opposition to Petitioner's primary contention that Petitioner feels that the most logical approach in this Reply Brief is to first address herself

[5]This is evident from an extract from the Government's brief before the Fourth Circuit in *Pridemark, Inc.* set out in Appendix A hereto.

to Respondent's contentions with respect to Rev. Rul 58-422.

Starting on page 40 of his Brief, Respondent attempts to distinguish Rev. Rul. 58-422 by focusing upon the final sentence of Section 332(b) of the Code; that sentence, by its terms, does not pertain to the liquidation of 100% owned subsidiaries such as the subsidiaries involved in Rev. Rul. 58-422, but expressly applies only where the parent corporation does not own all of the shares of the liquidated subsidiary. The meaning of the sentence is that a liquidation under Section 332 can occur even though minority shareholders are involved, and if the transaction is cast in the form of a reorganization the minority shareholders can receive the tax-free treatment. This is made clear in Treasury Regulations, § 1.332-2(d), cited by Respondent.

Even assuming Respondent's understanding of Section 332 were correct, this would not alter the simple fact that an amalgamation of three existing corporations into a newly formed corporation was involved in Rev. Rul. 58-422, and it is self-evident that the legal effect of the transactions considered in that ruling remains precisely the same whether the amalgamation of the subsidiaries is deemed to be a reorganization or liquidation. The effect of the amalgamation of three corporations considered in Rev. Rul. 58-422 was the same as the amalgamation of three corporations in the cases at bar, and the two amalgamations were accomplished in precisely the same manner.

Another perplexing aspect of Respondent's position with respect to Rev. Rul. 58-422 is his conclusion that "since there were two [*sic*—three] transactions the mere fact that they were consummated simultaneously in time does not alter their separate individual character." (Resp. Br., p. 42). This, of course, is the

very point of Petitioner's argument in her Opening Brief with respect to Rev. Rul. 58-422. In one breath Respondent states that the simultaneous statutory merger in Rev. Rul. 58-422 does not alter the separate individual character of the component transactions; yet in the next breath, he contends to the contrary in the cases at bar, stating that "there was a unitary agreement in which each step was made legally interdependent upon the other; and there was no intention evidenced, subjectively or objectively, that Stauffer California alone should undergo an "F" reorganization and retain its tax identity." (Resp. Br., p. 43). Respondent's contention is baffling since both Rev. Rul. 58-422 and the cases herein involved one simultaneous statutory merger, and thus the steps were identically interdependent in the two cases. The distinction which Respondent purports to see must therefore rest upon the absence of evidence of intention. This is, indeed, a novel construction of the law. Detailed examination of Respondent's arguments confirms Petitioner's assertions in her Opening Brief that Respondent views tax consequences under Section 368(a)(1)(F) as depending upon whether or not the taxpayer announces beforehand that a transaction is intended to be an "F" reorganization (Pet. Br., p. 53). Clearly, however, there is no requirement in the law that a taxpayer seek a prospective ruling from the Internal Revenue Service or announce its "intention" in some other way.

Turning now to the significance of Rev. Rul. 58-422 with respect to the primary argument of Petitioner herein—that the entire amalgamation constituted an "F" reorganization—Petitioner pointed out in her Opening Brief (Pet. Br., p. 51) that the holding in Rev. Rul. 58-422 had the effect of permitting all post-merger operating losses incurred by the successor corporation

to be carried back against the pre-merger profits of the parent irrespective of whether these operating losses were generated by the business formerly conducted by the parent or the businesses formerly conducted by the subsidiaries. Notwithstanding this obvious result of Rev. Rul. 58-422, Respondent, in replying to Petitioner's primary arguments herein, asserts that "it is apparent that Congress infused into the 1954 Code the single business enterprise theory that was adopted by the Supreme Court in *Libson Shops, supra,* and the First Circuit in *Newmarket Manufacturing Co. v. United States,* 233 F.2d 493" (Resp. Br., p. 27). This statement by Respondent is particularly perplexing and demonstrates the inconsistency of Respondent's arguments herein. In the first place, it is readily apparent that the holding in Rev. Rul. 58-422 is broader than the "single business enterprise theory" adopted by the Supreme Court in *Libson Shops* and the First Circuit in *Newmarket Manufacturing Co.* Under the theory of those cases, post-merger losses could only be carried back against the pre-merger income of the same business which produced the losses. However, under Rev. Rul. 58-422, the post-merger losses of all of the businesses of the three predecessor corporations can be carried back against the pre-merger income of the parent corporation, and this is a correct holding under the 1954 Code.[6]

While the "single business enterprise theory" is a narrower concept than that employed in Rev. Rul. 58-422, the "single business enterprise theory" does constitute the basis of Petitioner's third alternative argu-

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[6]As pointed out in Petitioner's Opening Brief (p. 24, fn. 8), this Court has specifically held that the "single business enterprise theory" is not applicable under the 1954 Code as to loss carryovers. *Maxwell Hardware Co. v. Commissioner* (9th Cir. 1965), 343 F.2d 713.

ment advanced in her Opening Brief; namely, that if this Court were to reject the holdings in *Pridemark* and *Davant, supra,* and also reject the holdings of Rev. Rul. 58-422, then the "single business enterprise theory" of *Libson Shops* should be applied so as to treat the three mergers as three separate "F" reorganizations. (Pet. Br., p. 60). The effect of this would be that the carry-back of post-merger losses would be permitted to the extent of the pre-merger income of the same business which produced the losses. This was the rule under the 1939 Code. See Rev. Rul. 59-395, 1952-2 C.B. 475, discussed at length in Petitioner's Brief, pp. 47-49. As pointed out in Petitioner's Opening Brief (Pet. Br., pp. 60-61), Petitioner introduced sufficient evidence before the Tax Court to establish the tracing of pre-merger income and post-merger losses (and Respondent does not deny this).

The admission by Respondent that the philosophy of *Libson Shops* and *Newmarket Manufacturing Co.* is applicable under the 1954 Code is extremely significant since these cases epitomize Petitioner's assertion in her Opening Brief that the efforts of the courts in recent years, and of the Congress in adopting the 1954 Code, have been to make economic realities rather than corporate artificialities determinative of the availability of loss carryovers and carrybacks. The *Libson Shops* case, of course, has already been discussed at some length by Petitioner. See pp. 20-25 of Petitioner's Opening Brief, and particularly pp. 24-25. As to *Newmarket Manufacturing Co.,* the rationale of that decision was carefully explained by that Court in its later decision of *F. C. Donovan, Inc. v. U. S.* (1st Cir. 1960), 261 F.2d 470, discussed in Petitioner's Opening Brief (Pet. Br., p. 64, fn. 23), in which the First Circuit made it clear that its decision in *Newmarket*

Manufacturing Co., far from being favorable to Respondent herein, fully supports Petitioner's position herein.

Respondent's summary of its position with respect to Rev. Rul. 58-422 (Resp. Br., pp. 42-43), and Petitioner's responses thereto, are as follows:

1. Respondent's contention: "First, the liquidation of the two subsidiaries is a separate transaction (under Section 332) from the reorganization of the parent."

Response: Similarly, we submit, the reorganizations of Stauffer New York and Stauffer Illinois constitute transactions separate from the reorganization of Stauffer California.

2. Respondent's contention: "Second, since there were two transactions the mere fact that they were consummated simultaneously in time does not alter their separate individual character."

Response: This, of course, Petitioner agrees with. Similarly, the fact that the transactions in the cases at bar were consummated simultaneously does not alter their separate character in the cases at bar. In the recent Tax Court case of *Dunlap & Associates, Inc.* (1967), 47 T.C. 542, discussed on pp. 28-30 of Petitioner's Opening Brief, the Tax Court followed this approach.[7]

3. Respondent's contention: "Third, a comparison with a situation in which the two transactions are separated in time indicates that the liquidation of the subsidiaries does not destroy a subsequent reincorporation of the parent."

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[7]Respondent attempts to distinguish *Dunlap* on the ground that there was no express provision in the documents that the transactions were legally conditioned upon the other (Resp. Br., p. 40, fn. 20). However, it is evident that the decision of the Court did not rest upon this formalistic nicety.

Response: Similarly, it is undisputed that in the cases at bar the loss carryback would have been available to Stauffer New Mexico if the transactions had been separated in time (Pet. Br., p. 18).

4. Respondent's contention: "Fourth, there is no reason why the liquidation should do so when it is consummated simultaneously with an "F" reorganization."

Response: This, of course, Petitioner agrees with, and this reasoning is equally applicable to the cases at bar. The Tax Court adopted this approach in its recent decision of *Casco Products Corp.* (1967), 49 T.C. No. 5, (Pet. Br., pp. 26-28).[8]

Thus, Respondent's arguments in attempting to rationalize the ruling in Rev. Rul. 58-422 merely operate to confirm Petitioner's contention that Rev. Rul. 58-422 governs the cases at bar. Moreover, although Respondent alleges that the "single business enterprise theory" should be applicable under the 1954 Code, the holding in Rev. Rul. 58-422 is itself incompatible with the "single business enterprise theory." Furthermore, Respondent ignores the fact that Petitioner has satisfied the "single business enterprise theory", and that this theory formed the basis of Petitioner's second alternative contention in her Opening Brief.

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[8]Respondent attempts to distinguish the *Casco Products* case by alleging that the case involved a redemption and not a reorganization. However, the whole point of the holding is that even though a merger had occurred, the Court would look to the substance rather than the form of the transaction and treat the transaction as if a redemption had occurred, thus permitting the post-merger losses to be carried back against pre-merger income.

III.

Respondent Cannot Support His Contention That Existing Law as to the Nature of an "F" Reorganization Should Be Overruled.

Turning now to Respondent's contentions with respect to the primary arguments advanced by Petitioner, these contentions and Petitioner's responses thereto, may be summarized as follows:

1. Respondent's contention: Petitioner's assertion that the touchstone of an "F" reorganization is continuity of ownership and business "would for all practical purposes erase any meaningful difference between an "A" and an "F" reorganization . . ." (Resp. Br., p. 14) and that "continuity of ownership and business enterprise is . . . true of every tax-free reorganization defined by Section 368(a)(1)." (Resp. Br., p. 18.)

Response: This, of course, is not so. The typical reorganization (whether type "A", "B" or "C") occurs between two unrelated entities, and clearly lacks the total continuity necessary for an "F" reorganization. The reorganizations in the cases at bar obviously are distinguishable inasmuch as they involve complete identity of ownership.

2. Respondent's contention: The examples in the explanatory Senate Finance Committee Report and the Treasury Regulations are inconsistent with Petitioner's contentions herein (Resp. Br., pp. 26-27).

Response: The very passage quoted by Respondent refutes his own position. After giving several examples involving the merger of unrelated corporations, the quoted passage goes on to qualify the result it arrived at under the facts of these examples by stating that if the transaction in question constitutes an "F" reor-

ganization, the carryback of post-merger losses is permissible. The quoted language does not in any way address itself to whether the statutory merger of the three identically owned corporations qualifies as an "F" reorganization.

3. Respondent's contention: The meaning of Section 381(c)(1)(A) is that "the acquiring corporation may not carry back the transferor's net operating loss to any of its pre-reorganization taxable years." (Resp. Br., p. 28).

Response: Section 381(c)(1)(A) expressly applies only to net operating loss carryovers and not net operating loss carrybacks, and thus is wholly irrelevant to loss carrybacks. Section 381(b) governs the right of the acquiring corporation to carry back losses.

4. Respondent's contention: A mechanical problem may arise if the carryback is permitted in those instances where the predecessor corporations were on different fiscal periods (which was not true in the cases at bar). (Resp. Br., pp. 29-31).

Response: This is by no means the only mechanical problem not contemplated by Congress in drafting Section 381. As pointed out in Petitioner's Opening Brief (p. 63), Congress could not have been expected to contemplate all permutations and combinations which would arise from such a complex statutory scheme, and the Regulations have in various instances attempted to bridge the gaps in the legislative scheme. For example:

(a) Congress did not provide in Section 381 for the possbility that more than one "acquiring corporation"

could be involved in a tax-free reorganization (see, Section 368(a)(2)(C) of the Code). Accordingly, the Regulations under Section 381 had to develop a set of "arbitrary" rules as to which corporation should be deemed to be the acquiring corporation where multiple acquiring corporations are involved (see Regs. §§ 1.381(a)-1(b)(2), 1.381(c)(2)-1(d), 1.381(c)(14)-1(e)).

(b) Congress did not provide for the possibility of multiple successive reorganizations, and accordingly the Regulations had to develop an elaborate network of "arbitrary" rules governing this possibility (see Regs. §§ 1.381(c)(1)-1(g),(h), 1.381(c)(1)-2, 1.381(c)(3)-1(f), 1.381(c)(6)-1(f), 1.381(c)(14)-1(d), 1.381(c)(15)-1(b), 1.381(c)(17)-1(e), 1.381(c)(21)-1(c)).

5. Respondent's contention: If Petitioner's position is correct, then "divisive" reorganizations must similarly qualify as "F" reorganizations (Resp. Br., p. 22).

Response: Perhaps the most intriguing aspect of this argument is how the Government will react if, in the typical "liqudation-reincorporation" situation (see Pet. Br., p. 34, fn. 11), the taxpayer reincorporates in two corporations rather than one. Such a situation will clearly not constitute a "D" reorganization (unless the requirements of Section 355 are met), and if the "F" reorganization provisions are not invoked, tax avoidance will be possible through the use of that reincorporation mechanism. Putting aside question as to how Respondent will react when the shoe is on the other

foot, it is evident that a holding herein that the mergers constitute an "F" reorganization would not extend to divisive reorganizations coming within the ambit of Section 355 of the Code. A Section 355 transaction (which may or may not be a reorganization) involves a distribution by a parent corporation of stock in a subsidiary corporation to the shareholders of the parent corporation. Said shareholders thereby become direct owners of the subsidiary corporation, and this, in turn, affords them tax avoidance opportunities which Section 355 restricts. Thus, such a divisive transaction is more than a mere change in identity or form, and, accordingly, if it is a reorganization, it is controlled by the "D" reorganization provisions (see, *e.g.,* Sections 368(a)(1)(D) and 354(b)). On the other land, if the divisive transaction does not qualify under Section 355, *e.g.,* the "liquidation-reincorporation" example used above, the "F" reorganization provisions might be invoked to preclude the tax avoidance which would otherwise be possible. See discussion, Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* (2d Ed. 1966) at pp. 494-5.

6. Respondents contention: The scheme of the reorganization provisions and the language and history of Section 368(a)(1)(F) indicate that the "F" provision is limited to formalistic changes in a single corporate enterprise (Resp. Br., p. 21).

Response: Petitioner regards this contention by Respondent as particularly erroneous, since this argument is diametrically contrary to the holdings in *Pride-*

mark and in *Davant*. Of course, in those cases it was the taxpayers who argued, albeit unsuccessfully, the very points which Respondent has now adopted as his own in the cases at bar. Indeed, Respondent so thoroughly embraces this argument in his Brief that he carries the argument to the extreme of stating that "[c]onsidered in its context, that language [*i.e.,* the definition of an "F" reorganization] simply means a reincorporation (a new charter) in the same or another state and no more." (Resp. Br., p. 21). It seems apparent, however, that if Congress intended that the language simply meant a reincorporation, Congress would have limited the definition of an "F" reorganization to a reincorporation; and obviously Congress did not. It is equally obvious that Congress had in mind much more than a mere reincorporation when it included a "change in . . . form, . . . however effected" in the definition of an "F" reorganization, since the word "form" has a special meaning arising from the "form vs. substance" distinction when used in the tax law.

In support of his position on the scope of "F" reorganizations, Respondent relies upon Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* (2d Ed. 1966). However, Respondent fails to call the Court's attention to the most recent comments on the subject in that publication, wherein the authors state as follows (1968 Supp. No. 1, pp. 40-41):

> "In two major recent government victories on the reincorporation issue, the Fifth Circuit adopted essentially the approach of Rev. Rul. 61-156,

finding both a D reorganization *and* an F reorganization: Davant v. Commissioner, 366 F.2d 874, 18 AFTR 2d 5523 (5th Cir. 1966); Reef Corp. v. Commissioner, 368 F.2d 125, 18 AFTR 2d 5832 (5th Cir. 1966). * * *

"But the Service's use of the F reorganization in the reincorporation area received a sharp setback in two recent Tax Court decisions: Est. of B. Stauffer, 48 T.C. 277 (1967); Associated Machine, 48 T.C. 318 (1967). There it was held that §368(a)(1)(F) was limited to fairly nominal changes in the structure of a *single* corporation, and did not apply to the instant cases, which involved the fusion of several brother-sister corporations. The Tax Court also overruled its earlier decision in the *Pridemark* case, which had found an F reorganization in a multiple corporate fusion situation; in addition, it refused to follow *Davant*."

It is apparent that the authors of that publication regard the decision of the Tax Court below in the cases at bar as unsound, inconsistent with Respondent's otherwise uniform position, and detrimental to the interests of the Government because of the opportunities it affords for taxpayer abuses in the "liquidation-reincorporation" area. See, generally, Bittker & Eustice, *supra,* at p. 569 *et seq.*

In Petitioner's Opening Brief, the posture of the law and of Respondent's position as to the broad scope of the "F" reorganization provisions was extensively treated (Pet. Br., pp. 33-36), and accordingly will not be repeated here. However, it is again respectfully submitted that Respondent's arguments here are totally in-

consistent with those he has made elsewhere on the scope of the "F" reorganization provisions.

Inasmuch as all authorities in the income tax area support Petitioner's contentions herein, Respondent was driven to look elsewhere for support of his contentions as to the narrow scope of the "F" reorganization provisions, and he has chosen to rely upon two documentary stamp-tax cases, *Cabot Corp. v. United States,* (D. Mass. 1963), 220 F. Supp. 261; aff'd *per curiam* (1st Cir. 1964), 326 F.2d 753; and *Columbia Gas of Maryland, Inc. v. United States,* (Ct. Cl. 1966), 366 F.2d 991. Both of these cases involved only the interpretation of the documentary stamp-tax provisions of the law and therefore are not relevant to this proceeding. It is interesting to note, however, that although the Court in *Cabot* held that the transaction did not constitute an "F" reorganization within the meaning of the documentary stamp act provisions, nonetheless it was undisputed by the parties that the transaction did constitute an "F" reorganization for purposes of the income tax law. Indeed, the taxpayer in the *Cabot* case had secured a ruling to this effect from the Internal Revenue Service. The *Cabot* case involved a parent corporation, two wholly-owned subsidiaries, and a third subsidiary which was 95% owned. The transactions in question in the *Cabot* case were strikingly similar as those in the cases at bar; namely, a new corporation was formed in another state, and the predecessor parent corporation and its three subsidiaries were simultaneously merged into the new corporation. The Internal Revenue Service ruled (in accordance with Rev.

Rul. 58-422, *supra*) that this amalgamation of the four predecessor corporations was (i) an "F" reorganization of the parent corporation, (ii) an "A" reorganization (statutory merger) of the 95% owned subsidiary so far as the minority shareholders of that subsidiary were concerned, and (iii) a Section 332 liquidation of the subsidiaries so far as the parent corporation was concerned. A full copy of that ruling, as set forth in the taxpayer's Brief before the First Circuit in *Cabot,* is set out in Appendix B hereto. In view of that ruling, it is perplexing how Respondent can rely upon the *Cabot* case. In fact, *Cabot* completely refutes Respondent's arguments herein, as to both Respondent's rejection of Petitioner's primary arguments herein and Respondent's rejection of the applicability of Rev. Rul. 58-422. *Cabot* involved the very things which Respondent here asserts cannot give rise to an "F" reorganization; namely:

(a) An amalgamation of multiple corporations in one simultaneous merger.

(b) A statutory merger constituting an "A" reorganization, separate and independent of any "F" reorganization that may have otherwise been involved.

Columbia Gas was a split 3 to 2 decision, involving a divisive reorganization which, as heretofore observed, is manifestly distinguishable from the cases at bar. Moreover, the Court was only concerned with the interpretation of an exemption from the documentary stamp taxes, holding that the exemption should be narrowly construed.

THE "ERRONEOUS ASSESSMENT" ISSUE.

I.

Neither Stauffer New Mexico nor the Petitioner Has Transferee Liability With Respect to the Refund Made.

With respect to the money refunded to Stauffer New Mexico, Respondent's reply can best be analyzed by restating Petitioner's three arguments:

1. Stauffer New Mexico did not purport to file a refund claim on behalf of Stauffer California.

2. Stauffer New Mexico could not possibly have filed a refund claim on behalf of Stauffer California under the applicable statute, Section 381(b)(3), since that section of the Code clearly and expressly gives the right of carryback, not to Stauffer California, but to Stauffer New Mexico.

3. In order to hold Petitioner liable as a transferee, Stauffer New Mexico must itself be a transferee, which it is not, since there was no obligation of Stauffer California, choate or inchoate, existent on the date of merger.

In response to Petitioner's first argument, Respondent asserts (Resp. Br., p. 45) that it has the right to waive the "formal" requirement that Stauffer New Mexico state in its claim for refund that it was acting on behalf of Stauffer California. That, however, is not the point at all. The point is that Stauffer New Mexico did not act, and did not intend to act, on behalf of Stauffer California.

As to Petitioner's assertion that Section 381(b)(3) specifically gives the right to refund to Stauffer New Mexico and not Stauffer California, Respondent merely asserts that Stauffer New Mexico, under the statute, has only a "procedural right" to claim the refund. This

is neither what the statute says nor what the statute means. The right to a refund vested in Stauffer New Mexico, and not Stauffer California.

As to Petitioner's third point that there could not have possibly been transferee liability in Stauffer New Mexico for the tax refund, Petitioner argues two points:

(a) Stauffer New Mexico admitted its obligation as transferee for any deficiencies in the tax of Stauffer California (Resp. Br., p. 47).

(b) In any event, it is not necessary for Stauffer New Mexico to have transferee liability, since Stauffer New Mexico is primarily liable for any deficiency in Stauffer California's taxes.

The first fallacy in both these assertions is in the assumption that the tax refund constituted a deficiency of Stauffer California; this assumes the very point in issue. The refund to Stauffer New Mexico is not a deficiency in Stauffer California's taxes; it is a refund granted to Stauffer New Mexico as a result of operating losses incurred by Stauffer New Mexico after the merger occurred.

The second fallacy is Respondent's assertion that Stauffer New Mexico admitted its obligation for any deficiencies in the tax of Stauffer California. The relevant language of Form 2045, upon which Respondent relies, is quoted in full text on p. 9 of his Brief, but is only quoted in partial text on p. 47 of his Brief where he discusses the point. The crucial language which Respondent failed to quote on p. 47 of his Brief states that Stauffer New Mexico's agreement to assume and pay taxes of Stauffer California is expressly limited as follows:

> ". . . to the extent of its liability at law or in equity, as a transferee within the meaning of Sec-

tion 6901 of the Internal Revenue Code of 1954 and corresponding provisions of prior internal revenue laws. . . ."

In short, Stauffer New Mexico by executing Form 2045 agreed only to pay such amounts as it was liable for as a transferee within the meaning of Section 6901 of the Code.[9]

In order for Stauffer New Mexico to be liable as a transferee of Stauffer California, Section 6901 of the Code requires that Stauffer California must have incurred the liability at law or in equity as of the date of merger of Stauffer California into Stauffer New Mexico. Obviously, there was no liability of Stauffer California for unpaid taxes, choate or inchoate, existent on the date of merger, since the refund that produced the alleged deficiency arose out of losses suffered by Stauffer New Mexico long after the date of merger. The posture of this proceeding is similar to the situation in *Yagoda* (1962) 39 T.C. 170, aff'd. (2nd Cir. 1964) 331 F.2d 485, acq. 1963-2 C.B. 5. In *Yagoda* the Government sought to establish transferee liability against a trust beneficiary based upon trust taxes which had erroneously been refunded after the trust had been terminated. The Tax Court held that the taxpayer was not liable as a transferee of the trust, since the tax deficiency caused by the refund was not an existing debt

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[9]At p. 47 of its Brief, Respondent cites *Commissioner v. Newport Industries, Inc.* (7th Cir. 1941), 121 F.2d 655, for the proposition that it is not necessary for Stauffer New Mexico to be a transferee. However, in that case the successor corporation specifically admitted its liability as transferee for the deficiency in question (see 121 F.2d at 655), and the issue was whether the deficiency was proper. Moreover, the deficiency therein arose out of facts occurring prior to the dissolution of the predecessor corporation, and thus is readily distinguishable from the cases at bar.

of the trust at the time the trust was terminated. The Court stated as follows (at p. 185):

> "The liability which the Commissioner now asserts arises because of the subsequent erroneous overassessment. To be sure, the trust has again become liable for 1944 taxes; but that liability, in the peculiar context of this case, is the consequence of events which transpired long after Lena became a transferee. * * *"

Conclusion.

Respondent has demonstrated no reason why existing law should be ignored and the taxpayer penalized as a result of reincorporating three corporations at the same time. The difficulties which Respondent purports to see are largely illusory, and to the extent they are existent, are no less susceptible of administrative solution than a multitude of other difficulties involved in applying the revenue laws. The very purpose of the loss carryback provisions would be frustrated if taxpayer were deemed to have forfeited the right to carry back these losses merely because the change in place of incorporation and merger were consummated at the same time, and the ability of the Government to defend against the "liquidation-reincorporation" tax avoidance device would be seriously jeopardized by adoption of Respondent's arguments.

In any event, it is evident that the "erroneous refund" applied for and received by Stauffer New Mexico is not properly an element of the deficiency of Stauffer California.

Respectfully submitted,

Gibson, Dunn & Crutcher,
Norman B. Barker,
Attorneys for Petitioner.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

NORMAN B. BARKER

APPENDIX A.

Extract from pp. 46-47 of taxpayer's brief before the Fourth Circuit in Pridemark, Inc. See footnote 5.

"The Tax Court held (R. 29, 35-36) that the 1958 and 1959 transactions 'clearly fall within both the letter and the intent of section 368(a)(1)(F) of the 1954 Code, * * *' A type F reorganization is defined as a 'mere change in identity, form, or place of organization, however effected.' The Tax Court states (R. 31) that this language is broadly phrased. The gist of the taxpayers' contention to the contrary (Br. 48), that a type F reorganization 'is the narrowest of the reorganization definitions', apparently is based upon their view that this type of reorganization is limited to a reincorporation in another jurisdiction. Such an interpretation eliminates from the definition the term, change of form. . . .' * * *

"Moreover, the taxpayers are not correct in their analysis (Br. 48-49) of the legislative history of the type F reorganization. Practically identical language to that now employed first appeared in Section 202(c)(2) of the Revenue Act of 1921, c. 136, 42 Stat. 227, and has remained substantially the same in all the succeeding tax statutes. Randolph Paul, in Studies in Federal Taxation (Third Series, 1940), pp. 22-23, 23-30, 81-82, indicates that while this provision may have originated to insure that a mere reincorporation in another state should not constitute a taxable event, this provision probably also was intended as a catch-all for cases not covered by other definitions. * * *"

APPENDIX B.

Ruling Letter.

(Seal)

U. S. TREASURY DEPARTMENT
Internal Revenue Service
Washington 25, D. C.

May 9 1961

Godfrey L. Cabot, Inc.
125 High Street
Boston 10, Massachusetts

Attention: Mr. Arthur H. Phillips
General Counsel

Gentlemen:

This is in reply to the letter dated July 25, 1960, in which a ruling is requested as to the Federal income tax consequences of the transactions the relevant facts of which are summarized hereinafter. Additional information was submitted in a letter dated September 22, 1960.

On the date of the request for ruling, Godfrey L. Cabot, Inc., ("Cabot") was a Massachusetts corporation which was engaged, largely through subsidiaries, in the manufacture and sale of carbon black, gas, oil, oil field pumping and drilling equipment, gun tubes, miscellaneous chemicals and certain other products. Cabot had outstanding 81,778 shares of no par value common stock.

On the date of the request for ruling, Cabot owned all of the outstanding stock of Cabot Shops, Inc.

("Shops"), and Cabot Gasoline Corporation ("Gasoline"), and 58,759 of the 61,900 outstanding shares of common stock of Cabot Carbon Company ("Carbon").

Carbon was a Massachusetts corporation engaged in the manufacture and sale of carbon black, oil and gas, and certain chemicals. Shops was a Massachusetts corporation engaged in the manufacture and sale of oil field pumping and drilling equipment and gun tubes. Gasoline was a Massachusetts corporation engaged in the production of butane, propane, natural gasoline and residue gas.

It was believed that substantial reductions in operating expenses could be achieved by reincorporating Cabot in Delaware. It was believed that additional savings could be made if Carbon, Shops and Gasoline were merged into Cabot.

Accordingly, Cabot Corporation ("Company") was incorporated in Delaware on July 14, 1960, and Cabot, Carbon, Shops and Gasoline were merged into it pursuant to the Delaware Corporation Law and the Massachusetts General Laws. The shareholders of Cabot received 30 shares of $1 par value common stock in Company in exchange for each share of Cabot outstanding immediately prior to the merger. The shares of Carbon owned by Cabot were cancelled and the balance of the Carbon stock was exchanged for Company stock in the ratio of 24 shares of Company for each share of Carbon stock held by the minority shareholders. The shares of stock of Shops and Gasoline were cancelled

and the 1,000 shares of Company stock issued and outstanding prior to the mergers were retired.

Based solely on the facts presented it is held as follows (all section references are to the Internal Revenue Code of 1954):

1. The merger of Cabot into Company was a mere change in place of organization and constituted a reorganization within the meaning of section 368(a)(1)(A) and (F), provided all of the requirements of the statutes of Delaware and Massachusetts permitting such merger were met. No gain or loss is recognized to Cabot as a result of the merger.
2. The merger of Carbon, Shops and Gasoline into Company, as outlined above, constituted in each instance, the complete liquidation of a subsidiary within the meaning of section 332(b). Under the provisions of section 332(a), no gain or loss is recognized to Company as a result of the liquidations. Pursuant to section 336, no gain or loss is recognized to Carbon, Shops or Gasoline.
3. As to the minority shareholders of Carbon, the merger of Carbon into Company constituted a reorganization within the meaning of section 368(a)(1)(A), provided all of the requirements of the statutes of Delaware and Massachusetts permitting such a merger were met.
4. In accordance with the provisions of section 354(a), no gain or loss is recognized to the shareholders of Cabot or to the minority shareholders of Carbon as a result of the exchange by them of common stock of Cabot and/or Carbon for common stock of Company.

5. Immediately after the transactions described above, the basis and holding period of the stock of Company received by each shareholder of Cabot and each minority shareholder of Carbon were the same as the basis and holding period of the stock exchanged therefor (sections 358(a) and 1223).
6. Immediately after the transactions described above, the bases and holding periods of the properties received by Company were the same as the bases and holding periods of those properties in the hands of Cabot, Carbon, Shops and Gasoline immediately prior to the transactions (sections 362(b), 334(b)(1) and 1223).
7. No gain or loss is recognized to Company as a result of the transactions ruled upon in the above ruling paragraphs (section 1032(a)).

Pursuant to the letter from Mr. Henry B. Jordan dated April 10, 1961, the rulings with respect to the transfer taxes payable on the transactions described above will be made the subject of a separate communication.

It is important that a copy of this letter be attached to the Federal income tax returns of Cabot, Carbon, Shops, Gasoline and Company for the taxable year in which the transaction took place.

Pursuant to the power of attorney on file in this office, a copy of this letter is being sent to Mr. Paul D. Yager.

Very truly yours,

Glen Paschall

Chief, Reorganization Branch

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PUBLIX WAREHOUSE, INC., Petitioner, vs. NATIONAL LABOR RELATIONS BOARD, Respondent.	)	Docket No. 22280

BRIEF OF PETITIONER

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Attorney for Petitioner

DATE: February 16, 1968

DUE: February 19, 1968

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PUBLIX WAREHOUSE, INC., Petitioner, vs. NATIONAL LABOR RELATIONS BOARD, Respondent.	)	Docket No. 22280

BRIEF OF PETITIONER

STATEMENT OF THE PLEADINGS AND
FACTS UPON WHICH JURISDICTION IS BASED

1. Petitioner is a corporation organized under the laws of the State of Alaska, having its principal place of business at Anchorage, and is engaged in the public warehouse business.

2. On February 1, 1967, the regional director of the Board, Region 19, Seattle, Washington, issued a complaint against Petitioner in Case No. 19-CA-3514, alleging that Petitioner had engaged in and was engaging in unfair labor practices effecting commerce within the meaning of Section 8(a)(1), (3) and (5) of the Act, effecting commerce within the meaning of Section 2(6), and (7) of the Act. The complaint was based upon an amended charge filed January 17, 1967, by Teamsters, Chauffeurs, and Helpers Local 959, (hereinafter referred to as the Union).

3. February 11, 1967, Petitioner duly served and filed its answer to the complaint denying each and every

allegation in the complaint and asserting that the Board lacked jurisdiction over the Petitioner in this action.

4. Pursuant to notice, a hearing was held on April 4, 1967, before a Trial Examiner designated by the Board. On July 14, 1967, the Trial Examiner issued a Recommended Order in which he concluded that Petitioner had engaged in certain unfair labor practices and recommended that the Board order Petitioner to cease and desist from in any manner interfering with, restraining or coercing its employees in the exercise of their rights to self organization. He further recommended that the Board order Petitioner to bargain collectively with the Union upon request and to take certain other affirmative action.

5. On July 14, 1967, the Board issued its order transferring the case to, and continued it before the Board for decision and order.

6. On August 3, 1967, Petitioner duly served and filed with the Board, its exceptions to the recommended order of the Trial Examiner, challenging the propriety and legality of certain of the Trial Examiners findings and recommendations which were adverse to Petitioner.

7. The Decision and Order complained of herein was rendered by a three man Board and served upon Petitioner on October 9, 1967..

8. This Court has jurisdiction of this proceeding pursuant to the provisions of Section 10(f) of the National Labor Relations Act, 49 STAT. 452, 29 USC Section 151, et seq., as amended by the Labor-Management Relations Act, 1947, 61 STAT.

146, 29 USC Section 141, et seq., (hereinafter referred to as the "Act").

STATEMENT OF THE CASE

The Petitioner operates a warehouse in Anchorage, Alaska, where it receives merchandise brought to it from out of the State, unloads it and then immediately or after a period of storage reloads the merchandise in trucks for distribution in Alaska.

Superior Shippers Association, Inc., a non-profit shipper's cooperative, is Petitioner's principal customer. In 1966, Petitioner paid out for the benefit of Superior which may be characterized as an advance, the amount of $118,166.91, of which payable to employee was $81,985.46 (TR-89). The dollar volume of sales and services rendered by Petitioner during 1966 to all other companies other than Superior was $34,686.69. The interstate portion of this revenue of Petitioner amounted to only approximately two-thirds of the total revenue of under $35,000.00 (TR-90).

In May, 1966, the Teamsters, Chauffeurs, and Helpers Local 959, affiliated with the International Brotherhood of Teamsters, Chaufeurs, Warehousemen and Helpers of America, Independent, (hereinafter called "Union") began to organize Petitioner's warehouse employees and thereafter filed a petition for representation election. By consent the election was held on September 15, 1966. The Union was certified as a collective bargaining representative on September 23, 1966.

The Respondent has found that by questioning employees about their feelings toward a union, by giving a wage raise to David Schacht and by promising one to Lance Brewster in an attem to get them to oppose the Union, and by instructing Dwane Philli to work Brewster and Walter J. Barth so hard that they would qui the Petitioner has interfered with, restrained and coerced employees in the exercise of rights guaranteed in Section 7 of the Act and has thereby engaged in unfair labor practices within the meaning of Section 8(a)(1) of the Act.

The Respondent further found that by imposing a layoff on Barth in the hope that he would quit, the Petitioner has discriminated in regard to Barth's tenure of employment in an effor to discourage membership in and support for the Union and has thus engaged in unfair labor practices within the meaning of Section 8(a)(3) of the Act.

It further found that the Petitioner had cut the hours of employees in the bargaining unit from 47-1/2 to 40 hours per week to retaliate against them because of their vote for the Uni and to induce them to quit. It alleged that the Petitioner had discriminated in regard to employee's conditions of employment to discourage membership in and support for the Union and has thereb engaged in unfair labor practices within the meaning of Section 8(a)(3) of the Act.

The Respondent further found that the Petitioner had changed the work hours of employees substantially affecting their earnings without affording the Union opportunity to bargain about this matter. Thereby the Petitioner was found to have refused to

bargain with the Statutory Representative of its employees and has thereby engaged in unfair labor practices within the meaning of Section 8(a)(5) of the Act.

The Petitioner denies each and every finding of the Respondent.

SPECIFICATION OF ERRORS

1. The Respondent erred in taking jurisdiction over Petitioner by finding that the Respondent derives revenues exceeding $50,000.00 annually for services in connection with the receipt, storage and loading of goods in commerce and that the Respondent is thereby engaged in commerce or in an activity affecting commerce within the meaning of Section 2(6) and (7) of the Act. (R-14)

2. The Respondent erred in finding that the Respondent instituted wage and hour changes affecting employees in the appropriate union and thereby engaged in an unfair labor practice. (R-19)

3. The Respondent erred in finding that the Respondent interfered with, restrained and coerced employees in the exercise of rights and has thereby engaged in unfair practices within the meaning of Section 8(a)(1) of the Act. (R-19)

4. The Respondent erred in finding that the layoff of Walter J. Barth and the cutting of weekly earnings of the warehouse employees resulted in discrimination in regard to the tenure of employment and conditions of employment of Barth and the other employees to discourage membership in the union.

SUMMARY OF ARGUMENT

The Respondent should not take jurisdiction over the Petitioner in this matter since the only way the Petitioner can be linked to interstate commerce is through Superior Shippers Association, Inc., a non-profit cooperative consolidation organization. Under its existing tests, the Respondent would not take jurisdiction over Superior, therefore, service to Superior should not form the basis of exercise of jurisdiction over Petitioner. The dollar volume of sales and services rendered by the Petitioner to all other customers in interstate commerce was approximately $28,000.00.

The Respondent went well beyond the complaint that was filed in this matter which only alleged activities between August 8, 1966 and September 30, 1966. The charges against the Petitioner were sustained on the basis of findings involving charges well outside the period of the complaint and are, therefore, irrelevant and were prejudicial.

The statements made by management to the employees were in the nature of predictions and not threats.

The layoff of Walter J. Barth was due to a lack of work and was not discriminatory.

The cutting of the employees from 47-1/2 hours to 40 hours per week was at the employees' request and was further due to a drop off in business. There is no law that states an employer must employ workers on an overtime basis. Such a finding should not be upheld in this case.

ARGUMENT

1. The Respondent erred in taking jurisdiction over Petitioner by finding that the Respondent derives revenues exceeding $50,000.00 annually for services in connection with the receipt, storage and loading of goods in commerce and that the Respondent is thereby engaged in commerce or in an activity affecting commerce within the meaning of Section 2(6) and (7) of the Act. (R-14)

The National Labor Relations Board (Board) has stated that it will exercise jurisdiction in future and pending cases involving freight transportation companies that furnish interstate transportation services and transportation or other enterprises that function as essential links in transportation of passengers or commodities in interstate commerce, where such companies and enterprises derive at least $50,000.00 gross annual revenue from such operations, or perform services valued at $50,000.00 or more annually for enterprises for which the Board would assert jurisdiction. In applying the "essential links" part of this standard, jurisdiction is not asserted on the basis of services performed for a company that meets the Board's standards only by virtue of indirect outflow or inflow. HPO Service, Inc. 122 NLRB No. 62, 43 LRRM 1127.

The only way that Petitioner can be considered to be an essential link in interstate commerce is by its services performed for Superior Shippers Association, Inc., (Superior), a non-profit cooperative consolidation organization. Superior is owned by approximately sixty (60) members who utilize the organization as a consolidation association for pooling freight on freight cars shipped from Seattle to Alaska. Mr. Moesh is the owner of Publix, being its sole stockholder and president. He

testified that Superior has nothing to do with Publix, that he is not the general manager of Superior, that Superior is directed by its board of directors from Seattle, that he has no profit making function in Superior. (TR-74). Employees in question in this proceeding unload freight from cars at Publix Warehouse which is then distributed locally in trucks belonging to Superior. The employees are paid with Publix checks for work performed for Superior but Publix does not derive any profit on labor cost. (TR-89). Publix paid out for the benefit of Superior which may be characterized as an advance, the amount of $118,166.91, of which payroll to employees was $81,985.46. (TR-89).

The dollar volume of sales and services rendered by Publix Warehouse, Inc. during 1966 to all other companies other than Superior was $34,686.69. If all of the revenue other than Superior or Publix was interstate in nature which it is not, Publix would still not come within the jurisdictional limits as set forth in the HPO Service, Inc. case. The interstate portion of the revenue of Publix amounted to only approximately two-thirds of the total revenue of $34,686.69. (TR-90).

The Board would not exercise jurisdiction over the operations of Superior alone, if these employees were those of Superior. In the case of Midwest Pool Car Association 114 NLRB No. 110, 37 LRRM 1023, the Board stated that operations of non-profit organizations formed for purpose of having merchandise loaded on freight cars for its members and distributing it to them upon arrival do not have sufficient impact upon interstate commerce to justify assertion of jurisdiction. In collecting

freight charges from its members, the employer is merely acting as their agent and money collected does not constitute revenue to an employer. As in the Midwest case, the members of the organization of Superior include retail and wholesale establishments. Superior makes no out-of-state purchases itself, and at no time has title to the merchandise it handles for its members. Goods purchased by the individual members are delivered by the Vendors to Superior in Seattle for consolidation into carload lots and delivery to the railroad. The cars are then sent to Superior in Anchorage which is responsible for the freight charges All deliveries are made within the State of Alaska. Each member of Superior is assessed for its proportionate share of the freight charges and for expenses.

The Midwest Pool Car case is still the law of the Board, and it is obvious that Superior would not come within the jurisdiction of this Board. In that event, under the decision in HPO Service, Inc. jurisdiction would not be effected against Publix since it does not perform services valued at $50,000.00 or more annually for enterprises over which the Board would assert jurisdiction.

Counsel does not see how the matter could be any plainer There are only three ways that Petitioner can come under the Board's jurisdiction under HPO Service standards:

(a) It must be engaged in the furnishing of interstate transportation services of at least $50,000. Publix is not.

(b) It must be a transportation or other enterprise functioning as an essential link in transportation in interstate commerce with $50,000 revenue. <u>Publix is not</u>

(c) It must perform services valued at $50,000 or more per annum for enterprises as to which the Board would assert jurisdiction under any of its jurisdictional standards. <u>Publix does not</u>, because Superior would not come under the Board's jurisdiction.

The Respondent apparently bases its jurisdiction under (b), but is this not specious reasoning? The only "link" could be that of a purely local service for Superior in Anchorage. If the transportation of the freight in interstate commerce by Superior for its own members is not felt to be important enough for the Board to exercise jurisdiction, how can the service of Publix be an essential link to that commerce. The Board's reasoning is a clear case of "pulling one's self up by your own bootstraps". Or, to put it another way, the "chain" of commerce is not critical nor deserving of jurisdiction, but the "link" is! We are sure the Board has more important work to do than build jurisdiction for itself on such tenuous reasoning.

2. <u>The Respondent erred in finding that the Respondent instituted wage and hour changes affecting employees in the appropriate union and thereby engaged in an unfair labor practice. (R-19)</u>.

It should be noted first of all that the complaint filed in this action only complains of matters that took place between August 8, 1966 and September 30, 1966. Yet the decision of the Trial Examiner dwells on facts and activities which took

place over an extensive period of time well in excess of that complained of in the complaint. These findings are irrelevant and should be disregarded by the Board.

The examination of the testimony by the various witnesses in this case shows that in only one case was any individual contract even remotely attempted to be negotiated with an employee or a wage increase offered during a period of August 8, 1966 to September 30, 1966. That was the case of Lance Brewster. In this case apparently Brewster, himself told Phillips (who was acting as a "pusher") that if he got $200.00 a week he would vote against the union. (TR-56).

3. <u>The Respondent erred in finding that the Respondent interfered with, restrained and coerced employees in the exercise of rights and has thereby engaged in unfair practices within the meaning of Section 8(a)(1) of the Act. (R-19).</u>

The testimony is clear that what statements were made by management were in the nature of predictions and not threats. At no time did any witness testify that Moesh or any other officer of Publix threatened them with any of the results set forth in Paragraph 6 of the complaint.

The NLRB frequently evaluates particular employer statements by distinguishing between illegal threats or promises and lawful predictions or prophesies or expressions of legal position. In the leading decision the NLRB made the following ruling:

> "A prophesy (by an employer) that unionization might ultimately lead to loss of employment is not coercive where there is no threat that the employer would use if he had any power to make its prophesy come true." <u>Chicopee Mfg. Corp.</u>, 107 NLRB 101, 33 LRRM 1064.

There is nothing in the record whatsoever that shows

that Publix would use any economic power to make any of the prophesies that Moesh made, come true. Publix did not have the economic power to make any of such statements come true. There is not a single reference in the record to any statement that work normally within the appropriate bargaining unit would be contracted out if the employees chose the union. Rather what Moesh stated was that Publix must continue to be competitive and if it was not competitive, Superior would take its business elsewhere, i.e. to the Alaska Railroad or Sea-Land Service for distribution. Statement by employer that he might be forced out of business if he had to charge as much as the customer to do his own work has been upheld as an economic prophesy. NLRB vs. Transport Clearing, Inc., 311 F.2d 519, 52 LRRM 2034, CA 5, 1962. A further statement by the employer that under the union a company would not be able to provide continuous employment during the past year was found to be a lawful prediction. Texas Industries, Inc. vs. NLRB, 336 F.2d 128, 57 LRRM 2046, CA 5, 1966 There are many other cases in the same vein in the reports. It has also been held that coercive isolated employer statements to the effect that the plant would be closed down if the union won the election would not nullify an election. The Morganton Full Fashioned Hosiery Co., 107 NLRB 1534, 33 LRRM 1421 (1954).

The statements made by Mr. Moesh were all statements of predictions or prophesies or legal position and did not constitute an illegal threat or an illegal promise under the Act.

Under Section 8(c) of the Act, statements containing

no threats of reprisal or promises of benefit do not, in themselves, constitute interference with or restraint or coercion of employees in their right of self-organization. An employer may lawfully express his opposition to a union or to unionism in general, and he may argue against a strike or other considered activity provided he does not suggest that employees will be penalized for refusing to adopt his views. For example, derogatory remarks about unions, statements as to the evil affects of unionization, charges of union exploitation of employees, declarations as to the futility of unionization, and similar remarks are ordinary privileged as free speech. Thus, a statement was held privileged in which an employer declared that his employees would experience economic hardships should they join a union; a supervisor's declaration of anyone who joined a union was "nothing more than a cutthroat, gangster and an outlaw" has been permitted; a superintendent's isolated assertion that there would never be a union in any company in which he worked was found by the court not to be unfair practice; the NLRB itself has held a shutdown threat was not unlawful where solicitation of union membership during working hours was seriously interfering with production; abusive language in an anti-union letter, an admonition to "stay out of trouble", advising employees not to join a union, "appeals to reason", a characterization of a union as "outlaw", "wildcat", and "offbreed" - all these type statements have been held privilege. See CCH Labor Law Reports, Sections 5010-5045.

The Board is prevented by Section 8(c) from using

statements by an employer as a means of proving that he has committed unfair labor practice unless the statements themselves are coercive. CCH Labor Law Reports, Section 5020.18.

Once again, a threat must be distinguished from a mere prophesy. CCH Labor Law Reports, Section 3770. For example, statements to the effect that unionization would result in shutdowns have been held to be prophesies coming within the privilege of free speech, rather than unlawful threats constituting coercion under the Act, where the employer made it clear that the shutdowns would result from economic necessity as a result of paying union wage scales, and there was no threat that the employer would use its economic power to make the prophesy come true. The facts of this case show there should have been no finding of a violation of Section 8(a)(1) of the Act.

4. The Respondent erred in finding that the layoff of Walter J. Barth and the cutting of weekly earnings of the warehouse employees resulted in discrimination in regard to the tenure of employment and conditions of employment of Barth and the other employees to discourage membership in the union.

The Respondent cannot see any argument over the fact that the employees were receiving pay based on a 45 hour work week prior to September, 1966. During that month, hours of work were cut to 40 hours and wages were reduced accordingly. However, it is clear that the hourly rate per employee was not reduced. At the request of several of the employees, and the employer ascertaining a definite dissatisfaction with working on Saturday, the employees hours were reduced to 40 hours. There is nothing in the Wage and Hour Laws that requires an employer to provide overtime hours for its employees.

In the case of Schacht, he was receiving $230.00 in a week that he worked 47-1/2 hours. This is the equivalent of 51-1/4 hours of straight time, or $4.49 per hour. After the alleged cut in "Pay", the employee worked 40 hours for which he was paid $179.60. Clearly, this shows no wage cut, but merely a reduction in hours to a normal work week of forty hours. It is clear that the company was careful not to cut any one's wages.

The same analysis can be made for the other employee, and it will be shown that the hourly rate was $3.33 per hour. Every one of the employees confirmed that they worked 47-1/2 hours per week before the time they were cut to 40 hours. They were paid accordingly, and we fail to see how they have been prejudiced.

Respondent agrees that Barth was temporarily laid off, but only because he was not needed due to a decline in business. (TR-29).(See also Deegan's testimony at TR-94). There is no question that he was low man in seniority, and would have been laid off first under any circumstances. As soon as another man quit in about 10 days, Barth was re-hired. It would really be a stretch of the imagination to call this an unfair labor practice. Phillips worked 60 hours the week after Barth was laid off, but the extra work was on a Saturday. One customer wanted their freight in advance. (TR-86). It is our understanding that you cannot take overtime from a regular employee by calling in another employee on an overtime situation such as occurred that week This would definitely be the subject of a grievance under the present Teamsters' contract, if Phillips had been denied the overtime.

CONCLUSION: The Board has no jurisdiction over the Respondent. Even in the event that jurisdiction is found, the Respondent has not been guilty of any unfair labor practices. The decision of the Board should be overturned.

DATED at Anchorage, Alaska, February 16, 1968.

John M. Stern, Jr

JOHN M. STERN, JR.
Attorney for Petitioner

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document upon all parties to the above proceeding, by mailing copies thereof to them, or their attorneys, properly addressed with postage prepaid.

DATED at Anchorage, Alaska, February 16, 1968.

John M. Stern, Jr

JOHN M. STERN, JR.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

John M. Stern, Jr

JOHN M. STERN, JR.

No. 22,280

IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PUBLIX WAREHOUSE, INC.,
Petitioner

v.

NATIONAL LABOR RELATIONS BOARD,
Respondent

ON PETITION TO REVIEW AND SET ASIDE AND ON CROSS-PETITION FOR ENFORCEMENT OF AN ORDER OF THE NATIONAL LABOR RELATIONS BOARD

BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

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AUTHORITIES CITED

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BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

JURISDICTION

This case is before the Court upon the petition of Publix Warehouse, Inc. (hereinafter petitioner or Company) to review and set aside an order of the National Labor Relations Board issued against petitioner on October 6, 1967, pursuant to Section 10(c) of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Sec. 151, *et seq.*). In its answer, the Board has cross-petitioned for enforcement of its order. The Board's Decision and Order (R. 13-21,

26-27)[1] are reported at 167 NLRB No. 95. This Court has jurisdiction over the proceeding under Sections 10(e) and 10(f) of the Act, the unfair labor practices having occurred at Anchorage, Alaska.

COUNTERSTATEMENT OF THE CASE

I. THE BOARD'S FINDINGS OF FACT

Briefly, the Board, rejecting the Company's contrary contention, determined that the Company is engaged in commerce within the meaning of Sections 2(6) and (7) of the Act, and that the purposes of the Act will be effectuated by asserting jurisdiction over its operations.

The Board also found that the Company violated Section 8(a)(1) of the Act by interrogating employees about their feelings toward a union, by threatening employees with loss of employment and promising and granting wage increases in order to discourage their interest in the Union, and by imposing onerous working conditions on two employees because they supported the Union. The Board further found that the Company violated Section 8(a)(3) and (1) of the Act by reducing the weekly earnings of its employees and laying off one employee in order to discourage membership in the Union. Finally, the Board found that the Company violated Section 8(a)(5) and (1) of the Act by instituting changes in wages and hours without giving the Union an opportunity to bargain about such changes. The facts on which the Board's findings and jurisdictional determination are based are summarized below.

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[1] References to the pleadings reproduced as "Volume I, Pleadings" are designated "R." References to the stenographic transcript of the hearing reproduced pursuant to Court Rule 10 are designated "Tr." References to the General Counsel's exhibits and to petitioner's exhibits are designated "G.C. Exh." and "P. Exh.", respectively. Whenever a semicolon appears, references preceding the semicolon are to the Board's findings; those following are to the supporting evidence.

A. The Board's jurisdiction: the nature of the petitioner's business

The Company, an Alaska corporation, operates a warehouse in Anchorage where it receives merchandise, primarily foodstuffs, which generally arrive in railroad cars transported by ship from Seattle, Washington. The Company unloads the material; then, either immediately upon arrival or after a period of storage, the Company reloads the merchandise in trucks and distributes it to consignees in Alaska (R.13; Tr. 8-12, 17). The Company's principal customer is Superior Shippers Association, a non-profit shippers' cooperative which paid the Company $118,166.91 for unloading and delivery services in 1966. All of the shipments handled for Superior were from out of State. An additional $34,686.69 was received by petitioner from other customers, of which about two thirds came from interstate shipments (R. 14; Tr. 74, 78, 89-90, 97).

B. The unfair labor practices

During the early part of May 1966, the Union[2] began to organize petitioner's warehouse employees, approximately ten in number, after some of them had evinced an interest in having the Union as their bargaining representative (R. 14; Tr. 15, 32). On May 16, 1966, the Union requested recognition from the Company by registered letter sent to Francis Moesh, the Company's president. The request went unanswered (R. 14; Tr. 32-33). However, on May 28, Moesh took employee David Schacht out for coffee and told him that "in no way he [Moesh] wanted to go union, that he would push it to an election, [and] that he had to have someone on his side. . . ." Moesh said that he would raise Schacht's wages from $190.00 to $230.00 per week effective immediately, and asked Schacht what he thought of that and what he thought

[2]Teamsters, Chauffeurs, and Helpers Local 959, affiliated with the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America, Independent.

of the Union. Schacht was non-committal, saying only that he would "think it over," and accepted the proffered increase (R. 14; Tr. 38-41).

In June 1966, Dwane Phillips was hired by petitioner. During his employment interview, Phillips was asked by Company president Moesh "how [Phillips] felt about unions." Phillips replied "it didn't make any difference one way or the other." Moesh then said that "he paid union wages there but he did not want to go union" (R. 15; Tr. 61-62). About a month and a half later, around the middle of August, Moesh, Schacht and Phillips went to a local tavern after work. After Schacht left, Phillips told Moesh that the latter "would make money even if he was to go union." Moesh replied, however, that "he absolutely didn't want anything to do with the Union affiliation," and added that "he would close the warehouse down before he would go union" (R.15; Tr. 63-64). Approximately a week later, Moesh again discussed the Union with Phillips and said, "He would absolutely not negotiate a union contract, he would close down first . . . and he also mentioned he couldn't afford to go union." Moesh further indicated he was "real disgusted" because employees Schacht and Fred Benton "went toward the union way of thinking." During one of these two discussions, Phillips was given a wage increase from $170 to $180 per week by Moesh (R. 15; Tr. 64-65).

Walter J. Barth applied for work at the warehouse in the late summer of 1966. He was interviewed by President Moesh, who asked him how he felt about the Union. Barth replied that "the union had good and bad points . . . [as did] non-union. . . ." (R. 14; Tr. 46-47). Moesh hired Barth, who started working part-time in the evenings because he did not wish to quit his previous job without giving two weeks notice to his employer. Barth began working full time on September 10 (R. 14-15; Tr. 50).

The Union petitioned the Board on August 8, 1966 for a representation election among petitioner's employees, and the election was scheduled for September 15 (R.14; Tr. 33). On September 14, President Moesh approached Barth in the ware-

house and told him that "if the union came in . . . he wouldn't be able to keep us working year around. . . . That he would have to start contracting the work out to Sea-Land . . . and that would mean that [Barth] would be out of some work" (R. 15; Tr. 47). The same day Dwane Phillips separately urged Lance Brewster and Barth "to vote on the side of management"[3] (R. 15; Tr. 65-66). Later in the day, Phillips and Brewster again discussed the Union, and Brewster said, referring to his position favoring the Union, that "[i]f Jake Moesh came up to me and paid me $200 a week, I would probably go the other way" (R. 15; Tr. 56, 66-67). Phillips reported this conversation with Brewster to Moesh, who thereafter sought Brewster out (R. 15; Tr. 56, 67). The two men went to the "coffee room" in the warehouse, where Moesh said that "if the union came in he would have to resort to sea land trailers to ship his freight and he could not afford the union, he couldn't afford to have anyone tell him how to run his business." Moesh also asked Brewster how long he had been employed at the warehouse, and Brewster answered eleven weeks. Moesh then said, "I will raise your pay to $200 a week and after you have been here two more months I will make it $230 a week." When Moesh asked him what he "would do" with respect to the Union, Brewster replied that he would "think about it." Moesh also inquired of Brewster what Barth "would do", and Brewster answered that "he would probably do what I do." Moesh then indicated to Brewster that he would raise Barth's pay to $200 after Barth had been employed eleven weeks, and after an additional two months Barth would "be raised accordingly" (R. 15; Tr. 56-57).

Notwithstanding the efforts of President Moesh, the Union won the election and was certified as collective bargaining

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[3] Although Phillips had previously been a strong supporter of the Union and had even solicited a Union authorization card from Brewster, he had a change of heart and "began to sympathize with [Moesh's] point of view" as a result of his discussions with Moesh (R. 15; Tr. 55, 65-66).

representative on September 23 (R. 14; Tr. 21-22). After the election results became known on September 15, employee Phillips apologized to Moesh and to Dean Deegan, petitioner's Secretary-Treasurer, "for not being able to talk Brewster and Barth into voting their way. . . ." Moesh replied that he was "highly disgusted because he lost the election" and that "there would be a change in the employees generally." Thus, Moesh said, Barth would be laid off in the hope that he "would get discouraged and find other employment;" other employees, particularly Schacht and Benton, "would be disgusted" and would quit "when they saw their checks," which would be cut by as much as fifty dollars a week (R. 15, 16-17; Tr. 67-70).

On the Saturday following the election, Moesh told Barth that he was laid off because there was insufficient work on hand, but that Barth should check in the following week. Barth did so, but was again told he was not needed. He was finally recalled on October 5, two and a half weeks after the initial layoff. When Barth returned, however, he found that Phillips, who now occupied the position of "pusher" or lead man, was "unfriendly". As Barth further described his situation, Phillips "kind of rode me and tried to make me quit" (R. 15; Tr. 48-49, 51-52). Brewster, though he was not laid off, also found that his relations with Phillips after the election had become unpleasant because Phillips "seemed like he was always mad or trying . . . to get me to quit or leave" (R. 15; Tr. 58). According to Phillips, he had been instructed by Moesh to "put enough pressure" on Brewster and Barth to induce them to leave, and thus he "rode Brewster and Barth so damned hard that under ordinary circumstances ordinary men would quit." (R. 15; Tr. 69-70, 71-72).

Prior to the election, the warehouse employees worked 47½ hours per week. After the election, however, their hours were reduced to 40 and their earnings lessened accordingly. Schacht's pay, for example, dropped from $230 to $179.60; Brewster's and Barth's from $170 to $132.80 (R. 15-16; Tr. 26-27, 79, 92-93; G.C. Exh. 4, 5, 6). The Union was not con-

sulted in advance about the reduction in hours and wages, even though the Union's business agent had asked Moesh immediately after the election ballots were counted when it would be possible to start negotiating a contract (R. 16; Tr. 34-35).

II. THE BOARD'S CONCLUSIONS AND ORDER

On the basis of the foregoing, the Board concluded, in agreement with the Trial Examiner, that the Company was engaged in commerce or in an activity affecting commerce within the meaning of Sections 2(6) and (7) of the Act, and that assertion of jurisdiction over it was warranted (R. 14). The Board also concluded that the Company violated Section 8(a)(1) of the Act by interrogating employees during job interviews concerning their Union sentiments, threatening to close the warehouse or to subcontract work should the employees vote in favor of the Union, promising and granting wage increases in an attempt to dilute interest in the Union and to recruit opposition to the Union, and imposing onerous work conditions upon employees Barth and Brewster because they supported the Union; violated Section 8(a)(3) of the Act by laying off Barth and reducing the hours and the weekly earnings of the warehouse employees; and violated Section 8(a)(5) of the Act by instituting wage and hour changes affecting employees in the appropriate unit without giving the Union the opportunity to bargain about such changes (R. 19).

To remedy these unfair labor practices, the Board ordered the Company to cease and desist from the unlawful conduct found, to bargain with the Union upon request, and to post appropriate notices. Additionally, the Board's order requires the Company to make Barth and other employees whole for any loss of earnings attributed to their discriminatory treatment by the Company (R. 19-20).

ARGUMENT

I.

THE BOARD PROPERLY ASSERTED JURISDICTION OVER THE COMPANY'S BUSINESS

A. The existence of statutory jurisdiction is plain

As shown in the Counterstatement, the Company receives goods directly from out-of-state, unloads them, in some cases stores them for a period of time, and then reloads them on trucks and distributes them to their consignees within the state. Without question, then, the Company's operations place it directly in the stream of interstate commerce, and that commerce would obviously be affected, within the meaning of the statute,[4] in the event the Company's business were disrupted by a labor dispute arising from unfair labor practices committed by the Company. Accordingly, the Company meets the statutory test for invoking the Board's jurisdiction. *N.L.R.B. v. Fainblatt*, 306 U.S. 601, 607. And see *N.L.R.B. v. Denver Building and Construction Trades Council*, 341 U.S. 675, 684-685; *N.L.R.B. v. Reliance Fuel Oil Corp.*, 371 U.S. 224, 226-227; *N.L.R.B. v. O'Keeffe Electric Co.*, ___ F.2d ___, 67 LRRM 2833 (C.A. 9); *N.L.R.B. v. Stoller*, 207 F.2d 305, 307 (C.A. 9), cert. denied, 347 U.S. 919; *N.L.R.B. v. Townsend*, 185 F.2d 378, 383 (C.A. 9), cert. denied, 341 U.S. 909.

The Company apparently does not quarrel with this fact (Br. p. 7), but argues instead that the Board, in asserting jurisdiction here, violated its own self-imposed jurisdictional

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[4] The Act states that the jurisdiction of the Board extends to any person ". . . engaging in any unfair labor practice . . . affecting commerce." Section 10(a), 29 U.S.C. Section 160 (a), as those terms are defined by Section 2(6) and (7) of the Act, 29 U.S.C. Section 152 (6) and (7).

standards. As this Court has pointed out, however, in *N.L.R.B. v. Carroll-Naslund Disposal, Inc.*, 359 F.2d 779, 780 (C.A. 9), "[i]t is settled law that the extent to which the Board chooses to exercise its statutory jurisdiction is a matter of administrative policy within the Board's discretion, . . . and is not a question for the courts, . . . in the absence of extraordinary circumstances such as unjust discrimination. . . ." See also *N.L.R.B. v. W.B. Jones Lumber Co.*, 245 F.2d 388, 390-391 (C.A. 9). We show below that the Board here reasonably applied its own jurisdictional standards and that no extraordinary circumstances are present warranting reversal.

B. The Company meets the Board's self-imposed jurisdictional standards

As a matter of administrative policy the Board has established certain jurisdictional standards, expressed in terms of annual dollar minimums, to determine under what conditions it will assert its jurisdiction over various types of businesses. *N.L.R.B. v. W.B. Jones Lumber Co., supra,* 245 F.2d at 391. Thus, in *HPO Service, Inc.*, 122 NLRB 394, 395, the Board announced that it would:

> assert jurisdiction over all passenger and freight transportation enterprises engaged in the furnishing of interstate transportation services, and all transportation and other enterprises which function as essential links in the transportation of passengers or commodities in interstate commerce, which derive at least $50,000 gross revenues per annum from such operations, or which perform services valued at $50,000 or more per annum for enterprises as to which the Board would assert jurisdiction under any of its jurisdictional standards.[5]

[5] See *N.L.R.B. v. Jordan Bus Co.*, 380 F.2d 219, 221 (C.A. 10).

As examples of what it considers to be "essential links," the Board referred to the enterprises involved in such cases as *Breeding Transfer Co.*, 110 NLRB 493, in which the employer, *inter alia*, performed local pickup and delivery service for goods coming to it from interstate commerce via interstate common carriers (railroads); *United Warehouse and Terminal Corporation*, 112 NLRB 959, 960, where the employer stored goods coming to it from out-of-state and subsequently released them for further shipment out-of-state; and *Kenedy Compress Company*, 114 NLRB 634, 635, in which the employer stored cotton apparently received from local sources, then shipped it out-of-state. See also, *Dallas Transfer & Terminal Warehouse Company*, 114 NLRB 18, 19, a case almost identical to the instant one, where the employer received goods from out-of-state, stored them and then delivered them locally.

From the foregoing, it is clear that the Board has consistently viewed enterprises such as that of the Company here as "essential links" in the interstate transportation of commodities. Further, the first alternative standard for asserting jurisdiction over such businesses—a gross of $50,000 or more per year from such operations—is fully satisfied based on the Company's receipt of $118,166.91 from Superior Shippers Association for its unloading and delivery services in connection with the goods coming to it directly from out-of-state. Accordingly, it is apparent that the Board properly applied its own standard in the present case.

The Company's contention that the standard was incorrectly applied here because the Company supplying the petitioner-Company with its business—Superior Shippers Association—is not itself subject to the Board's jurisdiction is without merit. The Company's argument is based on the erroneous view that jurisdiction was asserted here under the second alternative standard—performance of $50,000 worth of services for an enterprise over which the Board would assert jurisdiction. Although under that standard the Board would have to find Superior subject to its jurisdiction, *Kenilworth Delivery Service, Inc.*, 140 NLRB 1190, nonetheless,

as shown, jurisdiction here rests on the first alternative standard, not the second. Consequently, it is unnecessary to determine whether the facts here would permit application of the alternative standard.[6]

The Company's final suggestion (Br. p. 10) that the first alternative standard does or should take into consideration the volume of business done by each of the other "links" in the flow of the commerce is also groundless. Not only does the standard, by its terms, not depend on the amount of business performed by the other "links", but no sound reason appears why it should. The standard is specifically designed to cover entities directly involved in the movement of commodities in interstate commerce. The gross amount of revenue derived by any such entity from its services in connection with that movement is certainly a reasonable indication of the importance of that entity's contribution to the facilitation of the flow and a valid measure of its ultimate impact on the flow if a stoppage should occur at it. Further, a gross revenue of $50,000 or more from such an operation is hardly *de minimis*. *N.L.R.B. v. Jordan Bus Co., supra; N.L.R.B. v. Inglewood Park Cemetery Ass'n*, 355 F.2d 448, 451 (C.A. 9). Unlike chains, the strength or volume of the flow of interstate commerce is not determined by the size of each "link" associated with it. Consequently, the possibility that there may be other entities functioning as "links" in the same flow, which have grosses less than the amount specified in the standard and thus may make a proportionately smaller contribution to the flow, in no way detracts

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[6] However, while not relevant to decision herein, it should be noted that the Company misreads *Mid-West Pool Car Ass'n, Inc.*, 114 NLRB 721, 722, the case on which it relies in support of its claim that the Board would not assert jurisdiction over Superior. In *Mid-West* the Board did not conclude, as the Company appears to say, that it would never assert jurisdiction over non-profit shippers' associations, but only over those not meeting the dollar standard. The record here contains insufficient evidence to determine whether Superior's dollar volume is enough to meet Board standards. In addition, many of the statements in the Company's brief relating to the precise nature of Superior's business are not supported by record evidence.

from or warrants disregarding the significance of the contribution of an entity, such as the present Company, which makes the prescribed gross.

II.

SUBSTANTIAL EVIDENCE ON THE RECORD AS A WHOLE SUPPORTS THE BOARD'S FINDING THAT THE COMPANY VIOLATED SECTION 8(a)(1) OF THE ACT BY INTERROGATING EMPLOYEES AND MAKING COERCIVE THREATS AND PROMISES IN ORDER TO DEFEAT THE UNION

The credited evidence[7] establishes that almost immediately after Company President Moesh learned that the Union was seeking to organize petitioner's employees, he embarked upon an unlawful course of conduct to thwart the Union's efforts. Thus, he interrogated two job applicants, Phillips and Barth, in the course of employment interviews concerning their union sentiments; he offered or gave pay raises to Schacht, Phillips, Brewster and Barth if they would reject the Union; and he told Phillips, Barth and Brewster that he would shut down his business rather than accept a union, that he would lay employees off and sub-contract out their work if the Union won the election. It is settled that such conduct violates Section 8(a)(1) of the Act.[8] Moreover, after

[7]Petitioner offers no basis for setting aside the credibility findings of the Trial Examiner. As this Court only recently reiterated, such findings are entitled to "great weight" and "shouldn't be disturbed unless a clear preponderance of all of the relevant evidence convinces that they are incorrect." *N.L.R.B. v. Luisi Truck Lines*, 384 F.2d 842, 846; accord, *N.L.R.B. v. Gorlick et al*, 364 F.2d 508, 509 (C.A. 9).

[8]See, as to interrogation, *N.L.R.B. v. Ambrose Distributing Co.*, 358 F.2d 319, 320 (C.A. 9), cert. denied, 385 U.S. 838; *N.L.R.B. v. Security Plating Company*, 356 F.2d 725, 727 (C.A. 9); *N.L.R.B. v. West Coast Casket Co.*, 205 F.2d 902, 904-905 (C.A. 9); *N.L.R.B. v. Kolpin Bros. Co.*, 379 F.2d 488, 490 (C.A. 7); *N.L.R.B. v. Borden Co.*, __ F.2d __, 67 LRRM 2677, 2678 (C.A. 5). Cases such as *Wayside Press, Inc. v. N.L.R.B.*, 206 F.2d 862, 864 (C.A. 9), are not in point here for it is clear that the questioning occurred as part of a general pattern of anti-union activities committed by the Company. See, as

the election he deliberately imposed more onerous working conditions on Brewster and Barth because of their support of the Union and to induce them to quit. That his reason for so acting was a discriminatory one is clear. See *infra* pp. 16-18. Such conduct, therefore, is also violative.[9]

There is no merit to the Company's contention (Br. p. 11) that the pay increase given to Brewster was unimportant because it was Brewster who first suggested the idea. The fact remains that after Brewster's statement, Moesh sought him out on the day before the election and gave him the raise while indicating his firm opposition to the Union and making a promise of a similar benefit for Barth. In the Examiner's words, the payment was in the nature of a "bribe" (R. 16). Brewster's error in no way excuses Moesh's complicity, particularly since the other pay raises given and the reduction in pay after the election demonstrate that he was all too willing to raise or lower wages at any time under any circumstances for anti-union purposes. Since the raise was clearly hinged on the employee's vote in the election, it was violative. *N.L.R.B. v. Lowell Sun Publishing Co.*, 320 F.2d 835, 839 (C.A. 1). See also, *N.L.R.B. v. Exchange Parts Co.*, 375 U.S. 405, 409; *N.L.R.B. v. Laars Engineers, Inc.*, 332 F.2d 664, 666-667 (C.A. 9), cert. denied, 379 U.S. 930.

The Company's further argument that Moesh's statements "were in the nature of predictions and not threats" (Br. p. 11), permitted by Section 8(c) of the Act, has no substance. To be sure, the cases cited by petitioner, *N.L.R.B. v. Transport Clearing, Inc.*, 311 F.2d 519, 523 (C.A. 5) and *Texas Industries, Inc. v. N.L.R.B.*, 336 F.2d 128, 130 (C.A. 5)

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to promises and grants of benefits, *N.L.R.B. v. Luisi Truck Lines*, 384 F.2d 842, 845 (C.A. 9); *N.L.R.B. v. Security Plating Company, supra.* See, as to the threats to close the business and subcontract the work, *N.L.R.B. v. V.C. Britton Co.*, 352 F.2d 797, 798 (C.A. 9); *N.L.R.B. v. Kit Manufacturing Co.*, 292 F.2d 686, 688, 690 (C.A. 9).

[9]*N.L.R.B. v. Victory Plating Works, Inc.*, 325 F.2d 92, 93 (C.A. 9), enforcing 140 NLRB 389, 393; *N.L.R.B. v. Rutter-Rex Mfg. Co.*, 229 F.2d 816, 818 (C.A. 5).

hold that a "prediction that competitive conditions will force a plant to close if a union contract is signed is protected." But they also state that "a threat to close down in retaliation to unionization is beyond the pale."[10] Here, petitioner contends that "what Moesh stated was that Publix must continue to be competitive and if it was not competitive, Superior would take its business elsewhere . . . ." (Petitioner's brief, p. 12). However, insofar as Moesh may have testified to this effect, the Board did not credit it. Rather, the Board credited express testimony that Moesh told Phillips in August 1966 that "he would close the warehouse down before he would go union" (p. 4, *supra*); and, further, that Moesh separately told Barth and Brewster on the day before the election that he would "start contracting work out to Sea Land" if the Union won (p. 5, *supra*). Moreover, there is supporting evidence in the record that Moesh indicated to employees that he would take the threatened action, not because the Union would force him to do so or economic conditions resulting from unionization would compel such action, but rather "as a matter of principle" (*N.L.R.B. v. V.C. Britton Co., supra* at p. 798) and because of his distaste for collective bargaining. Thus, he informed Schacht at the start of the Union's campaign, ". . . I'll pay you more money, but I want to run my own business" (R. 15; Tr. 83). Additionally, he told Phillips when the latter

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[10]Thus, in *Transport Clearing, Inc.*, a supervisory official told one employee that "the employer might close if the employees went union," and told another employee that "there would be twenty-odd women walking the streets looking for jobs if the union came in because the doors would be closed tight." 311 F.2d at p. 521. The court found these statements to be coercive. On the other hand, the court refused to enforce that portion of the Board's order based "on evidence to the effect that the general manager stated that respondent, a cooperative non-profit organization representing freight motor carrier members, might be forced out of business if the motor carriers had to pay the company the same amount to operate as it would cost them to collect their own bills." 311 F.2d at p. 523.

was hired that "he paid union wages there but he did not want to go union" (p. 4, *supra*). And at a later date, when Moesh made the statement referred to above, about closing the warehouse, it was in response to a comment by Phillips that Moesh "would make money even if he was to go union" (*supra*, p. 4). Significantly, Moesh did not disabuse Phillips of this notion, but said that "he absolutely didn't want anything to do with the union affiliation" (*supra*, p. 4). In these circumstances, we submit that the Board was fully jusitified in concluding that Moesh's statements concerning a shutdown of the warehouse or subcontracting of work would reasonably tend to coerce employees and therefore violated Section 8(a)(1) of the Act. *N.L.R.B. v. Ambrose Distributing Co., supra; N.L.R.B. v. V.C. Britton, supra; N.L.R.B. v. Transport Clearing, Inc., supra;* Cf. *N.L.R.B. v. Miller*, 341 F.2d 870, 873 (C.A. 2); *N.L.R.B. v. W.C. Nabors Co.*, 196 F.2d 272, 276 (C.A. 5), cert. denied, 344 U.S. 865.[11]

Finally, the Company's contention that "the decision of the Trial Examiner dwells on facts and activities which took place over an extensive period of time well in excess of that complained of in the complaint" (Br. pp. 10-11), raises an immaterial issue. The "facts and activities" which the Company refers to all related to the Company's response to the Union's organizing drive and were part of a pattern of unlawful conduct. At the very least, they could be properly considered by the Board to show that the Company was engaged in a sustained effort to defeat the Union through illegal means and that subsequent events within the complaint period were not isolated incidents. The Company did not

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[11] This Court's recent decision in *N.L.R.B. v. TRW Semi-Conductors*, 385 F.2d 753, not only does not require a different result, but indeed tends to support the result reached herein. For the statements here, unlike those in *TRW* which the Court held to be privileged predictions because they related to events over which the employer has no control, clearly constitute "a threat of action which the employer can impose or control" (385 F.2d at 758) and which therefore are not privileged.

claim at the hearing and does not now assert that it was surprised by the evidence introduced by the Board or that it did not have full opportunity to litigate whatever matters were placed in issue by that evidence.

In any event, the only conduct here outside the complaint period—the raise for Schacht in May and the interrogation of Phillips in June—was exactly duplicated by other raises to other employees and the interrogation of Barth within the period. Therefore, even if these findings were disregarded, no modification of the Board's order would result, since the other findings based on the identical conduct within the period by themselves fully support the order.

III.

SUBSTANTIAL EVIDENCE ON THE RECORD AS A WHOLE SUPPORTS THE BOARD'S FINDING THAT THE COMPANY VIOLATED SECTION 8(a)(3) AND (1) OF THE ACT BY THE LAYOFF OF BARTH AND THE GENERAL CUTBACK IN HOURS AND WAGES

The undisputed facts show that, following the Union's election victory, the Company laid off employee Barth for two and a half weeks and reduced the weekly hours of work of other employees from 47½ hours to 40 hours; their weekly pay was diminished accordingly. The law is settled that such actions on the part of an employer are violative of Section 8(a)(3) and (1) of the Act if the employer were motivated by anti-union considerations. E.g. *N.L.R.B. v. Guild Industries*, 321 F.2d 108, 110-112 (C.A. 5); *Trumbull Asphalt Co. v. N.L.R.B.*, 314 F.2d 382, 383 (C.A. 7), cert. denied, 374 U.S. 808; cf. *N.L.R.B. v. Erie Resistor Corp.*, 373 U.S. 221, 227-228; *Shattuck Denn Mining Corp. v. N.L.R.B.*, 362 F.2d 466, 468-470 (C.A. 9).

On that score the record leaves no doubt. For, although "[d]irect evidence of a purpose to discriminate is rarely obtained" (*Corrie Corp. v. N.L.R.B.*, 375 F.2d 149, 152 (C.A. 4)), this is one of those unusual cases in which such

decisive evidence is present. Thus, according to the credited testimony of Phillips, Moesh told Phillips not only that he was "highly disgusted with the election results," but also what he intended to do about the matter. The events that transpired thereafter—the layoff of Barth, the reduction in hours and wages, plus the onerous working conditions imposed on Brewster and Barth (see *supra*, pp. 6, 12-13—were all part of the plan unfolded beforehand to Phillips by Moesh. The object, as Moesh explained to Phillips, was to induce the pro-union employees to leave (*supra*, p. 6). Once the words attributed to Moesh "are credited as having been said, their form and context and content eliminate all doubt on motive." *N.L.R.B. v. Ferguson*, 257 F.2d 88, 90 (C.A. 5). In short, Moesh's remarks to Phillips constituted "an outright confession of unlawful discrimination" (id. at p. 92), in which Moesh revealed in detail his intention to exact retribution against the employees for their vote for the Union and to induce them to quit so that the Union's support would be undermined.

The Company's assertions that the layoff of Barth and the reduction in the hours of other employees were the result of legitimate business considerations fail to withstand scrutiny. Specifically, Moesh's testimony that work was slack when Barth was laid off and therefore he had no need for Barth's services is scarcely plausible in view of the fact that Phillips was on "extended overtime" and worked sixty hours during the first week of Barth's layoff (R. 17; Tr. 68). Nor was Deegan's testimony that the Company experienced "a low period" after the election particularly persuasive. For while Deegan said that the Company "only had six cars a week for a period of six weeks," he failed to state how this differed from the number of cars the Company normally handled (Tr. 94). Equally dubious was the contention, "rather vaguely raised" by Moesh, "that the cut in hours was necessitated because the Union would have required overtime rates in excess of those the [Company] was able to pay . . ." (R. 17). Moesh had previously told Phillips that he was already paying "union wages," and in any event

did not discuss with the Union what wage rates the Union might be willing to accept (R. 17; Tr. 62).

In sum, in view of Moesh's "outright confession of unlawful discrimination" and petitioner's unconvincing explanation for its actions, the evidence supporting the Board's findings that the Company violated Section 8(a)(3) and (1) of the Act is not only substantial, but indeed virtually conclusive.

IV.

SUBSTANTIAL EVIDENCE ON THE RECORD AS A WHOLE SUPPORTS THE BOARD'S FINDING THAT THE COMPANY VIOLATED SECTION 8(a)(5) AND (1) OF THE ACT BY REDUCING HOURS AND WAGES WITHOUT BARGAINING WITH THE UNION ABOUT THE MATTER

Immediately following the election, the Union representative asked the Company to bargain. Despite this request, it is undisputed that the Company thereafter reduced hours and wages unilaterally and without prior consultation with the Union. That there was a real cut in hours rather than a reversion to a "normal work week of forty hours" (Br. p. 15) is clear. Thus, with respect to the number of hours the employees worked prior to the election, Moesh acknowledged, "I guaranteed so much a week whether they had freight or not" (Tr. 29). After the election, however, the situation changed—the hours and consequently the weekly pay of the employees were reduced—because, as Moesh further testified, "[i]f it was going to go union, you can't guarantee so much if you don't have any freight" (Tr. 29).

Section 8(a)(5) of the Act requires an employer to notify and bargain with the statutory representative of his employees, about significant changes in employees' working conditions before putting such proposed changes into effect. Plainly, a change in employees' hours—one of the subjects expressly mentioned in the statute—is a bargainable matter, *Weston and Brooker Company*, 154 NLRB 747, 763, enf. 373 F.2d 741 (C.A. 4), and the Company's action here,

taken without any discussion with the Union, was therefore violative. See *N.L.R.B. v. Johnson*, 368 F.2d 549, 551 (C.A. 9); *N.L.R.B. v. Yutana Barge Lines, Inc.*, 315 F.2d 524, 529-530 (C.A. 9); *Fibreboard Paper Products Corp. v. N.L.R.B.*, 379 U.S. 208, 209-214; *N.L.R.B. v. Katz*, 369 U.S. 736, 742-743. The possibility suggested in the Company's brief, p. 14, that the Company acted at the employees' request is immaterial. The Company's obligation is to deal with the Union exclusively. *Medo Photo Corp. v. N.L.R.B.*, 321 U.S. 678, 683-684.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that a decree should issue denying the petition to review and enforcing the Board's order in full.

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National Labor Relations Board.

April 1968.

CERTIFICATE

The undersigned certifies that he has examined the provisions of Rules 18, 19 and 39 of this Court and in his opinion the tendered brief conforms to all requirements.

Marcel Mallet-Prevost
Assistant General Counsel
NATIONAL LABOR RELATIONS BOARD

APPENDIX

The relevant provisions of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Sec. 151 *et seq.*) are as follows:

Sec. 2(6) The term "commerce" means trade, traffic, commerce, transportation, or communication among the several States, or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia or any Territory, or between points in the same State but through any other State or any Territory of the District of Columbia or any foreign country.

Sec. 2(7) The term "affecting commerce" means in commerce, or burdening or obstructing commerce or the free flow of commerce, or having led or tending to lead to a labor dispute burdening or obstructing commerce or the free flow of commerce.

RIGHTS OF EMPLOYEES

Sec. 7. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in section 8(a)(3).

UNFAIR LABOR PRACTICES

Sec. 8(a) It shall be an unfair labor practice for an employer—

(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7;

* * * * *

(3) by discrimination in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization: *Provided*, That nothing in this Act, or in any other statute of the United States, shall preclude an employer from making an agreement with a labor organization (not established, maintained, or assisted by any action defined in section 8(a) of this Act as an unfair labor practice) to require as a condition of employment membership therein on or after the thirtieth day following the beginning of such employment or the effective date of such agreement, whichever is the later, (i) if such labor organization is the representative of the employees as provided in section 9(a), in the appropriate collective-bargaining unit covered by such agreement when made, and (ii) unless following an election held as provided in section 9(e) within one year preceding the effective date of such agreement, the Board shall have certified that at least a majority of the employees eligible to vote in such election have voted to rescind the authority of such labor organization to make such an agreement: *Provided further*, That no employer shall justify any discrimination against an employee for non-membership in a labor organization (A) if he has reasonable grounds for believing that such membership was not available to the employee on the same terms and conditions generally applicable to other members, or (B) if he has reasonable grounds for believing that membership was denied or terminated for reasons other than the failure of the employee to tender the periodic dues and the initiation fees uniformly required as a condition of acquiring or retaining membership;

* * * * *

(5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of Section 9(a).

* * * * *

Sec. 10(a) The Board is empowered, as hereinafter provided, to prevent any person from engaging in any unfair labor practice (listed in section 8) affecting commerce. This power shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law, or otherwise: * * *

(b) Whenever it is charged that any person has engaged in or is engaging in any such unfair labor practice, the Board, or any agent or agency designated by the Board for such purposes, shall have power to issue and cause to be served upon such person a complaint stating the charges in that respect, and containing a notice of hearing before the Board or a member thereof, or before a designated agent or agency, at a place therein fixed, not less than five days after the serving of said complaint: *Provided*, That no complaint shall issue based upon any unfair labor practice occurring more than six months prior to the filing of the charge with the Board and the service of a copy thereof upon the person against whom such charge is made, unless the person aggrieved thereby was prevented from filing such charge by reason of service in the armed forces, in which event the six-month period shall be computed from the day of his discharge. Any such complaint may be amended by the member, agent, or agency conducting the hearing or the Board in its discretion at any time prior to the issuance of an order based thereon.

(c) * * * If upon the preponderance of the testimony taken the Board shall be of the opinion that any person named in the complaint has engaged in or is engaging in any such unfair labor practice, then the Board shall state its findings of fact and shall issue and cause to be served on such person an order requiring such person to cease and desist from such unfair labor practice and to take such affirmative

action including reinstatement of employees with or without back pay, as will effectuate the policies of this Act: * * *

(e) The Board shall have power to petition any court of appeals of the United States, . . . within any circuit . . . wherein the unfair labor practice in question occurred or wherein such person resides or transacts business, for the enforcement of such order and for appropriate temporary relief or restraining order, and shall file in the court the record in the proceedings, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall cause notice thereof to be served upon such person, and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to grant such temporary relief or restraining order as it deems just and proper, and to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board. No objection that has not been urged before the Board, its member, agent, or agency, shall be considered by the court, unless the failure or neglect to urge such objection shall be excused because of extraordinary circumstances. The findings of the Board with respect to questions of fact if supported by substantial evidence on the record considered as a whole shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence and shall show to the satisfaction of the court that such additional evidence is material, and that there were reasonable grounds for the failure to adduce such evidence in the hearing before the Board, its member, agent, or agency, the court may order such additional evidence to be taken . . . and to be made a part of the record . . . . Upon the filing of the record with it, the jurisdiction of the court shall be exclusive and its judgment and decree shall be final, except that the same shall be subject to review by the . . . Supreme Court of the United States upon writ of certiorari or certification as provided in section 1254 of title 28.

(f) Any person aggrieved by a final order of the Board granting or denying in whole or in part the relief

sought may obtain a review of such order in any circuit court of appeals of the United States in the circuit wherein the unfair labor practice in question was alleged to have been engaged in or wherein such person resides or transacts business, or in the United States Court of Appeals for the District of Columbia, by filing in such court a written petition praying that the order of the Board be modified or set aside. A copy of such petition shall be forthwith transmitted by the clerk of the court to the Board, and thereupon the aggrieved party shall file in the court the record in the proceeding, certified by the Board, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall proceed in the same manner as in the case of an application by the Board under subsection (e) of this section, and shall have the same jurisdiction to grant to the Board such temporary relief or restraining order as it deems just and proper, and in like manner to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board; the findings of the Board with respect to questions of fact if supported by substantial evidence on the record consid-as a whole shall in like manner be conclusive.

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PUBLIX WAREHOUSE, INC., Petitioner, vs. NATIONAL LABOR RELATIONS BOARD, Respondent.	)	Docket No. 22280

REPLY BRIEF OF PETITIONER

DATE: May 10, 1968

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PUBLIX WAREHOUSE, INC., Petitioner, vs. NATIONAL LABOR RELATIONS BOARD, Respondent.	Docket No. 22280

REPLY BRIEF OF PETITIONER

Petitioner replies to the Brief filed by the Respondent as follows. Petitioner will attempt to maintain the same paragraph headings as stated in the Respondent's Argument.

I. It is not proper for the Board to assert Jurisdiction over the Company's Business.

A. The existence of statutory jurisdiction is not certain.

As noted on Page 8 of Petitioner's Brief, the employees are paid with Petitioner's checks for work performed for Superior Shipper's Association, Inc. (Superior), but Petitioner does not derive any profit. (TR-89). Petitioner paid out for the benefit of Superior which may be characterized as an advance, the amount of $118,166.91, of which payroll to employees was $81,985.46. (TR-89). While the employees are carried on Petitioner's payroll records the arrangement is solely for the convenience of Superior, a non-profit organization, which actually is responsible for the payroll.

B. The Company does not meet the Board's self-imposed jurisdictional standards.

The Respondent continues to subvert the fact that the

nly basis for finding that the Petitioner meets one of the
oard's jurisdictional standards is the funds derived from a on-profit shipper's cooperative association which does not eet the Board's standards for jurisdiction.

Most of the cases cited by the Respondent on Page 10 f its Brief are not applicable since the services performed y the subject companies were performed in interstate services hat brought those companies within the Board's jurisdiction. e have consistently maintained that in this case the only asis for exercising jurisdiction over the Petitioner would epend on services performed for a company which the Board ould not find jurisdiction.

The Respondent accuses us of misreading the Mid-West ool Car Ass'n, Inc., 114 NLRB 721. We leave it to this Court o read the case. In Mid-West, the Board stated that operaions of non-profit organizations formed for purpose of having erchandise loaded on freight cars for its members and distriuting it to them upon arrival do not have sufficient impact pon interstate commerce to justify assertion of jurisdiction. he way Petitioner reads this case, it was not directed specically to the operations of Mid-West, but was a general statement of the Board upon which other parties would rely. To xercise jurisdiction over one company basing its jurisdiction n operations performed for a shipper's co-op, and then in the id-West case saying that such operations do not affect commerce ould unjustly discriminate against Petitioner under the theory et forth in National Labor Relations Board v. W. B. Jones umber Co., 245 F.2d 388, 391. In that case this Court stated hat the issue of jurisdiction would be justiciable if unjust

discrimination were involved in the consideration of one case and refusal to hear others unfair or lacking in due process.

We submit that Petitioner and other companies should be able to rely on standards set by the Board such as in the Mid-West case where such standards are made applicable to an entire industry. Otherwise, we have a system of one-way law, and the jurisdictional standards set by the Board for industry really have no meaning. In the instant case, the Board has not set forth any findings which justify a departure from the standards set forth in the Mid-West case. Mid-West is indeed applicable because the only way the Board can exercise jurisdiction over the Petitioner is through its activities for a non-profit pool car association.

In addition, the Petitioner stands on its assertions made on Pages 9 and 10 of its Brief and the Board's Argument on Page 11 of its Brief contains no law to contradict the Petitioner's Petition. Our contention is that the first alternative standard for asserting jurisdiction - a gross of $50,000 or more per year from interstate operations - should not take into consideration the business done by a so-called "link" in interstate commerce if the "chain" of commerce would not justify the Board's jurisdiction. We reiterate: If the transportation of the freight in interstate commerce by Superior for its own members is not felt to be important enough for the Board to exercise jurisdiction, how can the service of Petitioner be an essential link to that commerce.

and the Complaint dismissed.

DATED at Anchorage, Alaska, May 10, 1968.

John M Stern, Jr

JOHN M. STERN, JR.
Attorney for Petitioner

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document upon all parties to the above proceeding, by mailing copies thereof to them, or their attorneys, properly addressed with postage prepaid.

DATED at Anchorage, Alaska, May 10, 1968.

John M Stern, Jr

JOHN M. STERN, JR.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

John M Stern, Jr

JOHN M. STERN, JR.

United States

COURT OF APPEALS

for the Ninth Circuit

SODERHAMN MACHINE MANUFACTURING COMPANY, INCORPORATED,

Appellant,

v.

THE MARTIN BROS. TIMBER & CONTAINER COMPANY, INCORPORATED,

Appellee.

APPELLANT'S OPENING BRIEF

Appeal from the United States District Court for the District of Oregon

HONORABLE WILLIAM G. EAST, Judge

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Appellee.

APPELLANT'S OPENING BRIEF

Appeal from the United States District Court for the District of Oregon

HONORABLE WILLIAM G. EAST, Judge

JURISDICTIONAL STATEMENT

This is an appeal from a judgment rendered in the United States District Court for the District of Oregon by the Honorable William G. East, sitting without a jury, awarding defendant damages on its counterclaim in an action on a contract begun by plaintiff. The jurisdiction of the District Court rests upon the amount in controversy and diversity of citizenship (R. 1, 4, 9), 28 U.S.C. § 1332. Jurisdiction of this Court exists under 28 U.S.C. § 1291.

STATEMENT OF THE CASE

This is an appeal from a judgment awarding defendant damages on its counterclaim in an action initiated by plaintiff to recover the unpaid balance on a contract to construct and install a log debarking and chipping installation (R. 99). The action was originally filed to recover $61,395, plus interest (R. 11). Respondent counterclaimed that appellant had failed to complete the installation in certain respects, that the designing and installing of the system in other respects was insufficient and defective, that respondent had been compelled thereby to redesign and reinstall some units and to complete installation of other units, and that some of the units supplied did not meet the specifications and requirements of the contract (R. 13-21).

Appellant, Soderhamn Machine Manufacturing Company (hereinafter called Soderhamn), is an Alabama corporation engaged in the manufacture and sale of heavy equipment used in the wood products industry (R. 9).

Respondent, The Martin Bros. Container & Timber Products Corporation (hereinafter called Martin), is an Ohio corporation engaged in the milling, manufacturing and selling of various wood products (R. 9). Among its numerous operations was a lumber and plywood manufacturing plant at Oakland, Oregon. In 1961 Martin decided to install equipment to debark logs and to increase its capacity to manufacture wood chips, mainly for sale to paper manufacturers (Tr. 1017-1018). It received three proposals, including one by McManama and Company, Inc., which was a contractor experienced in the installation of the required

equipment. McManama's proposal was based on Soderhamn products as the principal items of equipment. Martin was unwilling to contract with McManama (Tr. 627), so Soderhamn prepared and submitted a proposal on its own behalf (Ex. 919).

After negotiations and some changes in the proposal, an agreement was reached on July 21, 1961, which together with a letter of August 11, 1961, was accepted by Martin and became the contract between the parties (Ex. 100). The only significant difference between the proposal and the contract was a provision that the barker system would "be mounted on steel piling, steel caps and with steel cross-bracing" instead of wood (Tr. 629; Ex. 100, p. 27). During the execution of the work there were 19 change orders executed by Martin, which resulted in a final contract price of $484,582.40 (Exs. 101-119, R. 10). The letter of August 11, above referred to as part of the contract:

1) Designated R. L. Kemp as Martin's representative with authority to determine changes in work or design, to accept charges not covered by the contract and to agree to delays;

2) Designated McManama & Co. as Soderhamn's subcontractor;

3) Provided for an all-risk insurance policy in lieu of a contractor's policy;

4) Provided for a policy on the life of Gerald McManama, president of McManama and Co., "in lieu of a performance bond"; and

5) Disclaimed any liability of Soderhamn for delays in completing the installation.

The contract was in four parts: Part I contained the general terms; part II described the principal units of equipment to be installed; part III described the installation of the principal units and included the necessary auxiliary components; part IV was a summary.

Parts II and III were divided into "phases." Phase I covered a "veneer core chipping system," which included the equipment to receive and chip peeler cores from existing plywood mill lathes and to convey the chips to an existing carloading station, with provision for later hooking the pneumatic system into a combined sawmill and veneer chip conveyor in Phase IV. Phase II covered the log barker system, including a 60″ Soderhamn debarker "to be installed as shown" on Exhibit 122, which was the only drawing in existence at the time of the contract (Tr. 48). (This drawing consists of a map showing the general layout of existing facilities at the plant and a schematic showing the debarker structure and system, including drawings of the structures and basic measurements and locations of the principal units.) This phase also included infeed and outfeed log conveyors, transfer decks, cutoff saws and three bark conveyors to transfer refuse from the debarking and sawing operations to a hammer hog which was to be installed and which was located on the schematic and described.

Phase III encompassed the sawmill chipper and chip loading system, comprising a "shaker roll" at the end of an existing sawmill refuse conveyor, a conveyor to a new chipper, a conveyor to a surge bin for sawmill and veneer chips and a pneumatic conveying system to move screened chips from the surge bin to be loaded into railroad cars. Phase IV provided for modification of the core chip pneumatic conveyor and

the veneer chip pneumatic conveyor system described in Phases I and III to form a single conveyor with double injection of chips. Phase V was to be a fuel bin, but this was eliminated by Change Order 19 (Ex. 119). The final contract was essentially the same as McManama and Co.'s proposal of May 10 (Ex. 10). The pneumatic conveyor components were the same as in proposals made to Martin by other bidders (Tr. 1570). McManama had had its crew on the job by late July or August 1961. The first work undertaken was the driving of piles required for structures in the various phases (Tr. 632). Construction of Phase I (the core chipper) was then carried out. This component was completed and accepted by Martin on Kemp's recommendation in March, 1962 (Tr. 708).

Early in its operation the chipper was accidentally seriously damaged when a piece of steel from a mill lathe fed into it. The insurance covered the loss and a new chipper was installed by Soderhamn. Part of defendant's original claims related to this reinstallation and part related to the pneumatic conveyor away from this chipper.

The phases were not installed in order (Tr. 1340). Soderhamn had never before made a 60″ barker (but it had sold several smaller barkers which McManama had installed in western plants, some of which had been inspected by Martin's representative Kemp before the contract was signed). (Ex. 904, Tr. 17-20). The barker was fabricated and assembled at the Kenton Machine Works in Portland (Tr. 77). In the meanwhile Martin was interested in increasing chip production from its existing facilities, so Phase III (the sawmill chipper) was next to be built (Tr. 1340). There was already a sawmill refuse conveyor which emptied into a conveyor to a burner at a 15-20°

angle (Tr. 1345-46). The proposal called for a "shaker roll" over which sawmill refuse would pass; the rolls would shake off sawdust and permit small unchippable blocks and other undesirable materials to drop through to the burner conveyor.

From the rolls chippable material was to be conveyed to a chipper, thence into a pneumatic conveyor, which under Phase IV was to be part of the double injection system to convey core and sawmill chips to be loaded in railroad cars. This installation was completed in January 1962 and Phases I and IV were paid for in April 1962 (Tr. 708). Part of defendant's claims related to alleged inadequacies in the shaker rolls, part to alleged deficiencies in the chipper and part to alleged inadequacies in the Phase IV pneumatic conveyor system (R. 18, 19).

Phase II (the barker) was the last to be installed. The log haul was installed on the piling earlier put in, followed by the infeed and outfeed conveyors, the transfer decks, the saw deck, the saws and, finally, the 60″ barker. The barker was first placed into operation in June, 1962. During this phase there developed substantial disagreements over contract requirements, and some of defendant's claims are based on these disagreements. After completion its operation gave rise to numerous problems, dissatisfactions and complaints on which some others of defendant's claims are based (R. 13-17). After McManama left the job in September, 1962, Martin undertook substantial repairs, additions and alterations in and to the system as installed, upon which it based some of its claims.

At various times during the construction Martin revised its requirements, relocated components from the places shown in Exhibit 122, made demands for

equipment or structures not expressed in Exhibit 100 and entered into numerous separate agreements with McManama for things not mentioned in the contract. Some of defendant's claims are based on these elements as they relate to the various phases. Beginning in February 1963, 7½ months after its installation, the barker's bearing system failed six times and was repaired by Soderhamn without charge to Martin (Tr. 79-80). In August Martin shut down the barker, allegedly because of a seventh bearing failure, and demanded that Soderhamn take the machine back (Ex. 781). In November, 1963, after the initiation of this litigation, Soderhamn removed the barker pursuant to stipulation that it could be so removed without prejudice to the rights and contentions of either party (R. 10), and it was resold.

Plaintiff's complaint was filed in April, 1963. The demand was for the unpaid balance or, alternatively, in *quantum meruit* for the value of the performance less the amount paid. Defendant counter-claimed for damages. The Pretrial Order (§ III, Plaintiff's Contentions, R. 11-12) reflected the unpaid balance claim (less the adjustment by reason of resale of the barker), and the alternative claim for the reasonable value of materials, work and labor furnished under the contract.

On defendant's counter-claim the Pretrial Order (§ IV, Defendant's Contentions, R. 13-21) detailed the claimed defects and deficiencies under some 19 headings summarized as follows:

1. The barker foundation was so constructed that it vibrated excessively, so that defendant had to have it gusseted, rewelded and braced.

2. The log haul chain would not stay on its sprock-

ets and the chain return slides were inadequate, so that defendant had to redesign the haul, install a chain tensioning device and put in adequate slides.

3. A. "Kicker shafts" to actuate devices on the barker structure had to be replaced.

3. B. Additional bearings on the shafts had to be installed.

3. C. "Kicker arms" were too light and had to be replaced with heavier material.

3. D. Defendant expended money to secure the installation of a steel transfer deck, as allegedly required by the contract, over and above the cost of the wood deck proposed by plaintiff.

3. E. Defendant failed to install concrete or steel pits under the hog, its surge bin and feeder.

4. Defendant had to replace steel plating on "knees" installed to guide logs from the barker outfeed conveyor and saw deck into the pond.

5. The refuse conveyors under the barker were insufficient in number and location, so that defendant had to install two additional conveyors.

6. A. Plaintiff failed to install sufficient "shrouding" to direct saw deck refuse to the conveyors underneath.

6. B. Defendant had to install two additional log lifts for the saws and install additional lift guides for all saws.

6. C. The sinker deck transfer chain drive interfered with lift truck operation and had to be relocated.

6. D. Defendant had to pay for installation of a roof over the sawing equipment.

7. The hydraulic system had to be substantially repaired.

8. The barker specifications of the contract were not met, and the barker was defective in that it would not provide variable tension on the chisel saws, the ring bearings were insufficient to permit sustained operation of the barker and the barker would not completely debark large logs; and frequent failures resulted in down time and attempted repairs. (Damages claimed under this head included expenses of installation, operation and removal for repair, removing, rebuilding and replacing the bark structure, extra labor, and replacement of the barker with a different machine).

9. The barker control console had to be relocated.

10. The refuse conveyor to the hog had to be redesigned and reinstalled.

11. Plaintiff failed to paint the pneumatic conveyor pipe.

12. A. Defendant had to supply a sawmill refuse slasher saw as part of the sawmill chipper system.

12. B. To make the sawmill refuse chipper system operable (including the shaker roll) it had to be redesigned and installed.

13. Plaintiff failed to install a sawmill chipper of the size required by the contract, which necessitated a new machine being installed.

14. A roof had to be installed over the conveyor from the sawmill chipper to the loading bins.

15. The dual injection pneumatic chip conveyor was of inadequate capacity to handle the chip production.

16. Plaintiff failed to install brushes to clean the bark and chip conveyor belts and chains.

17. Defendant expended money to secure the installation of steel decks and walkways on the barker structure, as allegedly called for in the contract, over and above the cost of the use of wood proposed by plaintiff.

18. Miscellaneous materials, machinery, labor, and insurance were furnished by defendant in connection with installation and construction required to be done by the plaintiff.

19. Defendant suffered a loss of profits expected to be derived from the sale of chips.

In each instance a specific dollar amount was asserted.

The Pretrial Order (§ V, R. 22) set out 16 issues of fact and law.

The matter came on for trial before Judge William B. East, sitting without a jury, and was tried over a period of 9 trial days (R. 110). More than 700 exhibits comprising more than 1200 items were received. Thereafter the matter was taken under advisement, and briefs were submitted by the parties.

On April 8, 1967, Judge East issued a memorandum opinion (R. 53-54) in which he: 1) refused "to review the evidence in this opinion"; 2) concluded that "the defendant has made a better case for its contentions"; 3) reduced the questions in the case to three: "1) 'Whether the contract, fairly and reasonably construed, under the usual rules of construction, required Soderhamn to make certain installations as the part of a complete log debarker-chipping system.' "; "2) 'Whether Soderhamn failed to perform

the contract as to certain items provided for therein . . .' "; and "3) '. . . the sufficiency and workability or insufficiency of certain items' " and 4) ignored the detailed questions of law and fact in the Pretrial Order.

Thereafter defendant submitted Proposed Findings of Fact and Conclusions of Law which differed from its Pretrial Contentions as follows (numbered by defendant's contention numbers):

6. A. Amount claimed reduced from $2,975.47 to $1,917.06.

6. B. Amount claimed reduced from $9,563.54 to $7,395.66.

(These reductions reflect elimination of claims for replacement of certain decking ordered by Kemp from McManama, a bearing replaced in maintenance, and one of the log lifts allegedly required to be and not supplied under the contract.)

6. D. Amount claimed reduced from $2,534.59 to $1,161 by abandonment of defendant's claim that plaintiff was liable for extension of the saw deck ordered by Martin.

7. Amount claimed reduced from $2,915.06 to $2,130.76 by elimination of claim for oil purchased in 1963, after the alleged deficiencies had been corrected.

8. Amount claimed reduced from $97,500, the alleged amount to replace the Soderhamn barker with a comparable size barker of a different manufacturer to $81,500, the contract price of the Soderhamn unit. This reduction reflects a theory that in effect Soderhamn never supplied a barker under the contract.

12. A. A $2,900 claim for a slasher saw in the mill under the contract was abandoned.

12. B. Amount claimed reduced from $10,287.74 to $9,531.57 by elimination of charges admittedly not covered by the contract.

13. Amount claimed reduced from $18,035 to $800 by abandonment of a claim that plaintiff failed to perform and recognition that the contract was modified by the parties with respect to this item of machinery.

18. All claims abandoned except 18 E, for insurance, which was reduced slightly.

19. Claim for loss of revenue abandoned.

Defendant thus abandoned claims totaling about $84,000.

Plaintiff filed its Objections to the proposed Findings of Fact and Conclusions of Law (but conceded Findings of Fact numbers 11 and 13, and conclusions of law number 1, and $218.40 of conclusion of law number 2 (R. 73-74)) and requested additional and different Findings of Fact and Conclusions of Law (R. 55-74), to which defendant filed Objections (R. 76-78). Thereafter plaintiff moved for a hearing on its objections (R. 80). The motion was summarily denied on June 27, 1967 (R. 83). On June 29, 1967, Judge East signed the Findings of Fact and Conclusions of Law submitted by the defendant and entered judgment for defendant on its counterclaim, including interest from January 1, 1964, and costs.

Plaintiff timely filed Notice of Appeal to this Court and duly perfected this appeal.

SPECIFICATIONS OF ERROR

1. The trial court erred in making Findings of Fact 1 through 10, 12, and 14 through 18 inclusive, in § II of its Findings of Fact and Conclusions of Law (R. 86-93) in that they, and each of them, are clearly erroneous, because they are contrary to law, against the weight of the evidence and not supported by the record.

2. The trial court erred in making Conclusions of Law 2 through 6 (except that portion of Conclusion of Law 2 allowing defendant $218.40, R. 94, line 1) for the reason that they, and each of them, depend upon Findings of Fact which are clearly erroneous.

3. The trial court erred in entering judgment against appellant based on erroneous Findings of Fact and Conclusions of Law.

4. The trial court erred in including in its judgment any allowance for interest, for the reasons that defendant was not entitled to interest as a matter of law, and that defendant in its demand for relief did not demand interest.

5. The trial court erred in failing to allow plaintiff's motion to strike the testimony of the witness Ray Martin:

> "MR. DUNN: . . . While Mr. Martin is on the stand, I would like to make another motion.
>
> * * * * *
>
> That all of Mr. Martin's testimony which he has given from the stand pertaining to the amount expended for these various modifications and various repairs and his testimony to the fact that such expenditures were reasonable be stricken from the record, because he testified that he had

no independent knowledge, that he was testifying from Exhibit 929. . . . (Tr. 1259)

THE COURT: I will deny your motion." (Tr. 1261)

Mr. Martin's testimony (Tr. 845-1255) in support of damages was based on time cards, invoices and other things contained in Exhibit 929 and concerned matters about which he had no direct personal knowledge except the matters in the exhibit, which he did not prepare. Record references to testimony specifically based on Exhibit 929 by Mr. Martin are as follows:

Tr. 888-889, 892, 895-896, 898-899, 903, 906, 908-911, 911-913, 917-918, 921, 926-927, 950, 963-964, 967, 971, 979-980, 1027-1029.

In each of the cited portions of the transcript Mr. Martin was testifying in support of a specific value in reference to a specific item of claimed damage, based on Ex. 929.

SPECIFICATIONS OF ERROR 1, 2 AND 3
SUMMARY

The trial court adopted as its findings and conclusions herein each and every proposal of the defendant on its counterclaim, but a review of the record, including the transcript and exhibits, demonstrates that (with one minor exception conceded by plaintiff and another which reflected a reduction of damages from more than $18,500 to the amount of $800 conceded by plaintiff) the defendant failed to produce substantial evidence supporting the amounts claimed and allowed. It is apparent that Judge East failed to review the evidence adduced for and against the de-

fendant's contentions, for if he had he could not have made the findings and conclusions which, as specified, are clearly erroneous on the facts and the law. Moreover, the trial court so interpreted and construed the contract as to create a new and different one, imposing on the plaintiff obligations either contrary to the expressed ones in the contract or never contemplated by the parties.

ARGUMENT

Introduction

Judge East made extensive Findings of Fact and Conclusions of Law by adopting without change those proposed by the defendant pursuant to an opinion (R. 53) in which the judge specifically refused to set forth a review of the evidence. It is the burden of this part of the brief that the Findings of Fact were in every instance "clearly erroneous" within the meaning of F.R.C.P. 52 (a). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction a mistake has been committed." *United States* v. *United States Gypsum Company*, 333 U.S. 364, 394-395, 68 S. Ct. 525, 92 L. Ed. 746 (1948). The trial court "failed to make a sound survey of or to accord the proper effect to all the cogent facts, ..." *Nee* v. *Linwood Securities Company*, 174 F.2d 434, 435 (8th Cir. 1949). While "courts should be slow to impute to trial courts a disregard of their duties and responsibilities or want of diligence or perspicacity in evaluating . . . the weight of evidence" (*Noland* v. *Buffalo Insurance Company*, 181 F.2d 735, 739 (8th Cir. 1950), the plain, unvarnished and unfortunate truth is that Judge East (with the

transcript and exhibits available to him) did not really make the Findings of Fact and Conclusions of Law herein, but accepted without a sufficient review of the facts or the law the defendant's position, apparently in the belief that there would be an appeal in any event so that what he did would make little or no difference (R. 83).

The Statement of the Case (supra, 2-12) outlines generally the context out of which this appeal arises. But in order better to comprehend the impropriety of the trial court's challenged Findings of Fact and Conclusions of Law it is necessary to understand in greater detail more of the factual background relating to the relationship between the various parties and individuals during the performance of the contract. It would make this brief over long to set forth every jot and tittle, but many of the major points must be stated in detail. In a sense each separate finding is a judgment on a separate lawsuit.

After the contract was finalized and construction begun, there were 19 written changes inspired by Martin (Ex. 101-119); the order of phase completion was altered (Tr. 1340, Ex. 100); and the location of the Jeffrey hog was moved closer to the structure (Tr. 1399, Ex. 122). Soderhamn's subcontractor was used by Martin to make additional changes in the design; for example, Martin employed McManama to extend aprons and shrouding, to install a 4′ addition to the deck behind the saws, to change the location of the core chipper (Tr. 1333), to change the wood frame of the chipper building to steel (Tr. 725), to change the barker building from wood to steel (Tr. 1364), to change wooden decks to steel decks (including tearing out installed wood on the sinker deck), to add walks, to add a roof over the saw deck, to add pits for

the hog, to add a slasher saw in the mill, to add a 55′ conveyor, to add a 51½′ conveyor, to replace the core chipper destroyed by the accident of a chuck being fed into the chipper (Tr. 863, 1366). Some of these were covered in the change orders; others were just ordered by Martin and paid for to McManama. Each was made the basis of an element of the counterclaims. Moreover, Martin procrastinated for six months on deletion of Phase V and allowed the plans to be developed and the work to go forward on this phase before deciding to delete it (Tr. 1359, 1081-84). It paid Soderhamn nothing for this.

Throughout the course of this installation Martin demanded items which were not contained in the contract. The transcript at 902 illustrates how Ray Martin (the defendant's general manager) determined the contract requirements. He had a simple formula: his reading of the contract was controlling, and Soderhamn would be expected to perform or pay.

The sawmill chipper matter is particularly important, even though the original claim has been abandoned by defendant. In its pretrial contentions defendant asserted that plaintiff had failed to install a machine in accordance with the contract and claimed as damages \$18,500 on that account. Mr. Martin stuck to this point in his testimony, but after the trial defendant apparently recognized the fact that the parties had modified their contract and defendant had accepted in satisfaction a reduction (offered by plaintiff, Ex. 124) of \$800 in price. Still in the face of this, defendant refused to acknowledge acceptance of the machine and used its supposed deficiencies as a reason for refusing to make payments due under the contract (Ex. 506, p. 2), while using the machine to produce chips in the ordinary course of its business.

When all was said and done, defendant acknowledged that $800 was its due (R. 92). Again defendant demanded as part of the contract the installation of a slasher saw in the sawmill at a cost of $2,900 (Pretrial Order, R. 18), and Mr. Martin stuck to this claim in his testimony, even though the contract contained not a single provision calling for any installation in that mill. In the proposed findings and conclusions the claim was finally dropped. These, as well as other claims now dropped (supra, 11-12), demonstrate the difficulties Soderhamn had in performing its contract due to the attitude and actions of Martin.

Soderhamn made concessions that were not called for by the contract in an attempt to satisfy Mr. Martin. It donated a buck saw bar (Tr. 1643). It saved the Martin company $8,000 by donating a complete hydraulic system, eliminating Martin's having to supply the air which would have been necessary and which Martin had agreed to supply (Tr. 1056-1063, 1075; see Ex. 430; see p. 24 *infra*). In addition, Soderhamn paid $800 for a performance bond which was not required by the contract but which Martin demanded (Tr. 1063-65; see *infra*, p. 22). Soderhamn made no charge for the work done on Phase V, which Martin finally deleted (Tr. 1084). The contract also stated that "all work under this proposal is based on an 8-hour day and a 40-hour week" (Ex. 100, p. 3). Soderhamn nonetheless worked its crew overtime in an attempt to complete the job within a reasonable time. An extra log stop was provided without charge (Ex. 421), and Soderhamn provided a free plugging switch on the pneumatic system (Ex. 548).

It is clear that Martin specified, prior to the signing of the contract, the machines wanted. These were, in each instance, installed. It is also clear that

the buildings in which and upon which these machines were to be placed were not fully detailed before construction began. The agreement was that the details would be reduced to drawings and approved by Martin's Mr. Kemp. Martin was initially satisfied to have the buildings constructed similarly to those previously built by the McManama company at other plants and inspected by Martin's representatives (Ex. 904, pp. 17-20). In order to insure the buildings were built to its satisfaction, Martin established its maintenance engineer, Mr. Kemp, as the "owner's representative" to approve plans. Mr. Kemp had seen other installations made by McManama and was an old hand in the sawmill industry. He apparently enjoyed the confidence of Mr. F. J. Martin, Chairman of the Board. When he approved a plan or an installation orally, or in writing, the plan or the installation became the specification which was performed. Mr. Kemp, as the Martins' maintenance engineer, was in authority as the company's representative, spending 80% to 95% of his time overseeing this job (Tr. 700, 1066).

At the time of trial Martin was asserting claims against Soderhamn in excess of $260,000. Regardless of the merits of the claims themselves, it goes without question that Martin had the burden of establishing by a preponderance of the evidence the costs or damage incurred by them in connection with each item asserted as a claim. Moreover, even assuming that Martin proved Soderhamn had breached its contract in one or more of the respects claimed, Martin had the duty to mitigate its damages (*Enco* v. *Russell*, 210 Or. 324, 339, 311 P.2d 737 (1957). Repeatedly throughout the trial Soderhamn showed that Martin could have mitigated its damages, but instead chose

the most costly way to achieve what it thought it was entitled to.

The evidence produced by Martin at best left the record in a state of confusion and made it virtually impossible in most instances to determine with any degree of accuracy exactly what Martin would be entitled to by way of damages, if any, without indulging in speculation. To establish the amount of its damages Martin relied basically upon records produced from its files and the files of Sutherlin Machine Works. In conjunction with these records it attempted to utilize the testimony of three witnesses, Mr. Carl Halverson (of Sutherlin Machine Works), Mr. Kemp and Mr. Ray Martin.

Mr. Halverson relied upon documents marked as Ex. 921A through 921N and Ex. 931 to support the charges he had made to Martin for work done at their plant. He testified that Ex. 921A through 921N covered all work and material done for Martin (Tr. 384). The most that Mr. Halverson could say was that the documents he was referring to and relying upon as a basis for his testimony were records and summaries of records from his company covering charges made to Martin for work done on their barker and chipper installation (Tr. 353). He did not personally prepare the records produced, nor is there any evidence they were prepared under his supervision. He did not know the details of the claims being asserted against Soderhamn and obviously could not say whether the charges made to Martin should or should not be considered a part of their claims (Tr. 353-55). He had no independent knowledge of charges made for work done other than that contained in the exhibit he was referring to (Tr. 354).

Mr. Ray Martin, willing to testify on anything whether he had personal knowledge or not, relied upon documents contained in Exhibit 929. Exhibit 929 is a box containing files and folders separated into categories or classifications. The exhibit was offered and received (Tr. 665-669). There is considerable conflict in the testimony as to what Exhibit 929 is supposed to contain. Mr. Martin said Ex. 929 was not entirely business records (Tr. 1164). He had no knowledge of the facts contained in the exhibit (Tr. 893-894). He did not know how it was put together, who put it together, or what it contained (Tr. 1204). The exhibit was first introduced when Mr. Kemp was on the stand (Tr. 665). He did not know what was in the file and had only examined it briefly before trial (Tr. 665, 667). The exhibit contained records with notations made for purposes of trial, presumably by Mr. Kemp. Mr. Martin did not know what the notations meant (Tr. 1203). His testimony, insofar as it was based on Ex. 929, is the subject of a separate Specification of Error (*infra*, 91).

Faced with confusion and conflicts in connection with the exhibits, as well as the oral testimony relied upon to establish defendant's damages, it was impossible to ascertain with any degree of accuracy what defendant's claims were, let alone what defendant was entitled to, if anything.

The preliminary negotiations leading up to the actual contract were handled by Mr. Kemp (Ex. 904, p. 8). He was Martin's expert in the field of mill construction; he had previously negotiated for the same installation for Martin with Sumner Iron Works and Nicholson Manufacturing Co. (Tr. 696; Ex. 904, pp. 49-51). He inspected other similar installations

constructed by McManama to familiarize himself with the type of job he could expect.

The overall program for the construction of the installation was discussed, negotiated and crystalized in conferences between Mr. Kemp, McManama, and a representative of Soderhamn, before submission of the final proposal to the Martin family for approval. A formal contract was proposed, approved by Kemp and then submitted to the Martin family and their attorney. It was ultimately executed. Its terms demonstrate that the Martins were relying on Mr. Kemp to see that he got what he bargained for. Mr. Kemp was designated in the contract as the owner's representative (Ex. 100, p. 2). In the addendum to the contract of August 11 it was specifically spelled out that Mr. Kemp, as the owner's representative, "shall be deemed as between owner and contractor to have authority to determine for owner any changes to be made in work or design during the time the installation is in progress, to accept changes for *work or equipment not covered* by the contract and to agree to any delays which may be necessary * * *." (Emphasis supplied) (Ex. 100, p. 34)

Within a short time after the contract was signed, Mr. Ray Martin demanded Soderhamn supply a performance bond at a cost of some $800. Soderhamn basically is only engaged in the manufacture and sale of wood processing equipment, such as barkers and chippers, and is not in the contracting business. McManama, on the other hand, is a contractor, and Martin knew this. The Martin people had reservations as to McManama's financial status and insisted that Soderhamn assume the responsibility as the prime contractor. Martin had investigated Soderhamn and had satisfied itself as to its financial responsibility

(Tr. 1062). Notwithstanding this fact and the fact that no provision was made in the contract for a performance bond, Mr. Martin demanded one (Tr. 1063-65).

When Soderhamn acceded to Mr. Ray Martin's request but suggested that the cost of the bond should be for Martin's account (Ex. 416), Mr. Martin took offense and arbitrarily rejected the suggestion (Ex. 422). This is a small matter and under ordinary circumstances would not warrant attention. In retrospect, however, it graphically demonstrates the attitude which Mr. Martin was taking and, as it later developed, would continue to take in connection with this contract. It demonstrates the atmosphere in which Soderhamn was forced to operate throughout the performance of this contract.

At the outset the relationship of Solderhamn and McManama with Mr. Kemp was one of accord. Mr. Kemp, after substantial work had been done on the contract, volunteered the statement that the cooperation which he was receiving from Soderhamn and its subcontractor, McManama, and the work they were doing were excellent (Ex. 532). It is true that there were some minor differences of opinion, but in view of the magnitude of the construction job this was to be expected. Mr. Kemp had basically negotiated the contract and appeared to understand its terms. From time to time he was provided with detailed drawings of the various segments of the installation, as the same were developed, for approval or rejection. In most instances he approved them without change, but in many instances he exercised his authority under the contract to require changes or modifications in the proposed installation. Where the changes went

beyond the terms of the contract, he approved change orders to reflect the increase or decrease in cost.

One of the first changes in the contract was the substitution of an oil hydraulic system for air. This change is outlined in a letter from Soderhamn to Mr. Kemp, dated November 14, 1961 (Ex. 471). This change is significant in view of the position taken by Mr. Martin at the trial. At that time he contended that it was understood from the beginning that hydraulic power was to be used instead of air. When Mr. Martin was questioned on this at the trial, he stated that a Soderhamn representative brought a copy of the proposed contract to Oakland on July 19, 1961, and at that time certain changes were agreed upon, one of which was the substitution of hydraulic power for air, and subsequently the contract was amended to incorporate such change and resubmitted for approval by Martins on July 21, 1961. Discussing the changes made between the July 19th draft and the final draft of July 21, Mr. Martin's testimony on this point was as follows:

> "Q. Now you say that in the revision between 19th and the 21st that the power system was changed from air to hydraulic.
>
> A. Yes, sir.
>
> Q. You couldn't be in error on that, could you, Mr. Martin?
>
> A. It was discussed in the July 13th meeting, and during the meeting Mr. McManama made the statement that the—
>
> Q. Now, my question, Mr. Martin, was not about the 13th.
>
> A. Well—
>
> Q. My question was this. Are you certain that a revision was made between the 19th and the

21st to change from air to hydraulic? That is my question. Now, either 'yes' or 'no.'

A. Yes.

Q. That was made.

A. Yes." (Tr. 1054-55).

This testimony is in direct conflict with the documentary evidence consisting of letters from Soderhamn to Martin dated September 19, 1961 (Ex. 430), October 5, 1961 (Ex. 447A), and November 14, 1961 (Ex. 471), the sole subject of which was the proposed change from air to hydraulic.

The contract provided that payments would be made by Martin as the work progressed. Martin was authorized to retain 15% of the total amount due on each individual phase or system until its completion and during a 30-day training and break-in period after completion. The first trouble arose upon the completion of Phase III (Sawmill Chipper). The sawmill chipper installation was completed and placed in operation on January 10, 1962, and a 15% retention due on this phase was requested to be paid on February 10, 1962 (Ex. 496). Martin refused to pay, and contended that the chipper did not meet specifications (Exs. 497, 498). Martin persisted in this contention from that date through the trial. In the proposed findings and conclusions the claim was dropped. See 9, 12, *supra.*) In fact the chipper went into operation on January 10, 1962, and operated continuously until the sawmill was destroyed by fire in May, 1963.

In June, 1962, a meeting was held between representatives of Soderhamn and Martin to discuss pending problems in connection with the completion of the project (Ex. 602). At that time 14 separate items or grievances were listed by Martin. The results of this

meeting are outlined in Ex. 602. Subsequently there were numerous meetings and check lists submitted, considered and action taken thereon, as outlined in Exs. 606, 614, 618, 623, 626, 629, 645, 650, 659, 660, 664, 675, 676, 677, 678, 686, 691, 692, 698 and 716. Soderhamn took appropriate action on the checklists (Tr. 1642-1650). At one point in these discussions Soderhamn requested permission to send Mr. Tom Haley, an experienced sawmill engineer of Timbermen's Engineering Co., down to Oakland to inspect Martin's plant and give Soderhamn an independent evaluation of Martin's complaints. This request was refused (Ex. 702, 706). At a later date Soderhamn offered to submit the entire controversy to a team of experts for arbitration (Ex. 698). This request was likewise refused. (Ex. 692 covers the offer to submit to arbitration, and Ex. 698 covers the refusal.) Soderhamn tried in vain to arrange conferences with Martin's personnel in an effort to resolve the controversy (Exs. 792, 793, 794, 795, 796, 797, 798, 799, 800, 801, 802 and 803).

It became apparent that litigation was the only route that was feasible. The litigation took the shape outlined in the Statement of the Case herein. The trial resulted in Findings of Fact and Conclusions of Law which (except for two minor matters freely conceded by appellant) appellant maintains are clearly erroneous. There is with respect to this aspect to the appeal basically one error: The trial judge failed to find the facts and law in accord with the evidence. Therefore, appellant has organized its argument in the order of the Findings of Fact as they appear in the record (R. 86-93). Because the Conclusions of Law were simply statements of the amount of damages defendant was entitled to recover as a result of each Finding of Fact,

reference is parenthetically made after each finding subheading to the Conclusion of Law which follows therefrom and which is also erroneous.

The Challenged Findings

Finding of Fact 1. Barker Foundation Structure, R. 86 (Conclusion of Law 3, R. 94, line 14).

The trial court awarded defendant $11,609.73 on its claim that the welding on the barker foundation structure was insufficient. To support this claim Martin relied primarily upon the fact that it employed the Sutherlin Machine Company to add additional welding, bracing and gusseting. It was admitted that, although Soderhamn's subcontractor had completed its job in September, 1962, no complaint was made about the welding until after this suit was brought in April, 1963 (Tr. 98, 154, Ex. 904, pp. 82, 83). This last fact is particularly significant when it is considered that during this time three separate check-lists were authored by Martin setting forth the things they felt had to be completed before Soderhamn's responsibility under the contract would be finished (Ex. 602, 650, 675, 678, 686). Soderhamn had taken action on each check list. Martin's Mr. Kemp admitted that the few breaks that were found before McManama left the job were brought to the attention of McManama's foreman, and they were rewelded before he left (Ex. 904, p. 82). It is not uncommon to get breaks all the time around a sawmill (Ex. 905, p. 55, Tr. 494). Martin's master mechanic said they were still occurring a year after Sutherlin's work (Ex. 905, p. 55) (although Mr. Kemp swore in a deposition (Ex. 904, p. 88) that since Sutherlin finished there had been no more broken welds.)

The reason Martin gave for needing the additional welding seemed to be the matter of sway. Mr. Hill, an Oregon registered engineer, said at the trial (Tr. 1651) that in his professional opinion the vibration was not excessive or unusual (Tr. 1652). The experts expected to find movement in a steel structure. McManama, who had experience in five states in installing these types of device, stated that it was not excessive and added that he had suggested use of wood piling instead of steel because it made a more resilient structure (Tr. 1319). This had been rejected by Martin in favor of the steel for insurance reasons. Mr. McManama said the vibration did not cause problems (Tr. 1389). Mr. Tozier (who did the survey for Sutherlin) would not say that the vibration or sway caused electrical relays to go out, as contended by Martin (Tr. 337). Ray Martin, although quite willing to support the contention, admitted that he did not know anything about the broken welds (Tr. 1141) or welding (Tr. 1139) or engineering (Tr. 1180-81). Of course, he thought the movement excessive, but he admitted to being an office man and not a welder or an engineer (Tr. 849). McManama's supervisor, Mr. Morrison, stated that he saw no broken welds when he left the job in the fall of 1962 (Ex. 902, p. 25), and he didn't think it swayed too much (Ex. 902, p. 24). Mr. Tozier, of the Sutherlin Machine Company, said that he found no broken welds under the barker (Tr. 278-279). He did find places where there was no welding. Two registered engineers stated that they were unable to tell from the testimony of Halverson, Kemp and Tozier, and the other evidence, what was found or where it was found, so that no one could tell whether or not the work done by Sutherlin Machine Company had any beneficial effect on the structure (Tr. 1687, 1769-1770), but in their best judgment,

from what they saw and heard, they were of the opinion that the gussets put on by Sutherlin were not necessary (Tr. 1679, 1761-65).

Mr. McManama, after hearing all the evidence produced by Martin on this topic, stated it made no sense. He did not question that there were places where there was no welding (Tr. 1493). He made an interesting comparison to the frame of an automobile which has many "open seams"—which are supposed to be that way to give the frame the flexibility it needs to stay together under the stress and strain of the swaying body and other parts of the vehicle (Tr. 1494). Mr. Kintz, a registered engineer, said the gusseting was not necessary and was improperly installed (Tr. 1760, 1761). Some of the work he saw that was done by Sutherlin he unqualifiedly stated was a waste of money (Tr. 1765).

Mr. Wahl, of the Timbermen's Engineering Company, a registered engineer, said that the gussets, especially underneath the barker, were not necessary (Tr. 1679) and that if any bracing were necessary it could have been done more economically (Tr. 1682). His inspection of the structure showed that there was too much welding (Tr. 1684), and it was impossible for him to tell where Sutherlin applied their additional welding so that he could form an opinion as to whether or not it made the structure any stronger (Tr. 1686-87). He further stated that he could not tell from the testimony whether or not the movement involved would require any additional bracing (Tr. 1687, 1720). Having observed the work done by Sutherlin, he questioned whether any of it was necessary, stating that the structure is supposed to be elastic, citing the example of the Empire State Building (Tr. 1714). Mr. Delahaye, a practical welder, said

that in his opinion the Sutherlin welding was not necessary (Tr. 1614).

What occurred was that Mr. Kemp turned the Sutherlin Machine Company loose underneath the barker with full assurance that the bill would go to Soderhamn. They did so without giving Soderhamn any notice whatsoever of their intention (Ex. 904, p. 83). And they did so without any computation of what was needed (Tr. 405), or without any competitive bids or other outside analysis.

It seems fruitless to complain that the price was unreasonable when it is Soderhamn's position that the work was unnecessary. Martin did not sustain its burden to show that this work was reasonably necessary. It is certainly clear that the evidence amassed against this claim was unrebutted. It is also clear that Martin made no effort to mitigate its damages.

This claim is for $11,609.73. In support defendant relied on Exhibit 921 A, a group of invoices issued by Sutherlin to Martin, presumably for work done in welding and bracing the barker structure. Exhibit 921 A consists of 13 separate invoices. Mr. Halverson detailed work done on the barker structure (Tr. 364-366) and testified that his charges for such work were covered in Exhibit 921 A.

Invoice D1141 is a part of 921 A; it is for $3,084.32. The invoice contains the following:

"Repairs to Barker

Labor & balance of material this invoice
installed ¾″ Plate shears on log dump
Installed bark shears & guards around Barker
Reinforced framework under sawing deck
Installed ¾ & ½″ plate on block dump
Changed shaft & moved plate on block dump

Changed shaft & moved motor drive on
Sinker Deck

Replaced expandex metal w/dia. plate on
floor over hyd pumps.

Constructed windows around Barker
operator"

It is obvious that the items covered by the above invoice have nothing to do with the welding and bracing of the barker substructure as testified to and contended for by defendant and its witnesses.

The items referred to as "Installed ¾ plate shears on log dump" and "Installed ¾ & ½″ plate on block dump" would appear to refer to the "sheer aprons" referred to in defendant's contention numbered 4 in the Pretrial Order (R. 14) and Finding of Fact 4. If it means anything, it must represent a duplicate charge. It is significant that Mr. Halverson gave no testimony on this point. The only testimony on the cost of replacing the sheer plate was by Mr. Martin, and he was only reading from a file in his hand which he knew nothing about (Tr. 906).

The item "Installed bark shears & guards around Barker" would appear to be "shrouding on Barker Structure," defendant's contention 6-A in the Pretrial Order (R. 15) and Finding of Fact 6. It must also represent a duplicate charge. The item shown as "Reinforced framework under sawing deck" obviously refers to work done on the saw deck substructure which would appear also to be a duplicate of the costs defendant refers to under contention 6-A. It is to be noted that a part of the cost covered by invoice D1141 also covers "Replaced expandex metal w/dia. plate on floor over hyd. pump." "Expandex" was part of the steel deck flooring, not part of the foundation structure.

The item referred to in the invoice as "Changed shaft & moved motor drive on Sinker Deck" is the same work that Mr. Martin said was covered by Sutherlin invoice #1254 (Tr. 920) and is part of contention 6-C in the Pretrial Order (R. 16). It is interesting to note that Mr. Halverson testified (Tr. 348) that invoice #1254 (Ex. 921 J) covered work done on the log outfeed conveyor to speed up movement of logs. At no point did defendant assert any claim for reimbursement for this work. This merely demonstrates some of the confusion in the record on the matter of damages.

It is obvious that a substantial part of the sum of $3,084.32 represented by invoice #D1141 is not properly chargeable to repair of the barker substructure as testified to by Mr. Halverson and Mr. Martin. The record will not be cleared by merely eliminating this invoice or deducting the amount represented by the invoice, for there is nothing in the record to segregate the billing from the balance of the charges reflected in Exhibit 921 A and charged against the barker substructure. Exhibit 921 A contains 13 separate invoices. Most of them merely refer to "Welding and Bracing" on barker; no details are supplied. How much of the "Welding and Bracing" was connected with the replacement of the expandex, installation of sheer plates, or relocation of the sinker deck motor is purely a matter of speculation.

Soderhamn found itself in a frustrating position of being told in effect, "We don't like your installation, but we won't tell you what is wrong with it. We plan on correcting it, and when we get done we will send you the bill." Not until Martin filed its answers to interrogatories submitted during the course of pretrial discovery was Soderhamn advised what most of

Martin's specific complaints about the installation were. It was only then that Soderhamn learned that Mr. Martin had authorized Mr. Kemp to hand Sutherlin Machine Works a "blank check" to completely revamp the installation.

In sum: After the barker foundation structure was completed, after Soderhamn had undertaken to correct deficiencies claimed by defendant, and after Soderhamn's contractor had departed, the defendant undertook substantially to reconstruct the barker foundation structure. It did not request or demand that Soderhamn do the work. Instead it sought another party, allowed that party solely to determine the work to be done without any check or challenge and ordered the work to be done. It then sought to charge the cost back to plaintiff, and the trial court allowed it, even though (a) the record does not permit a finding of what work was actually done, or where it was done; (b) there is no convincing evidence that what Sutherlin did was necessary or even proper; (c) there is substantial evidence to the contrary; (d) the evidence of cost is confusing and, insofar at least as invoices 1141 and 1254 are concerned, is irrelevant, immaterial and, therefore, improper; (e) Martin made no effort to mitigate its damages; and (f) the finding and conclusion are purely speculative and unsupported by the record.

Finding of Fact 2. Log Haul, R. 87 (Conclusion of Law 3, R. 94, line 16).

For corrective work on the log haul, defendant was allowed $2,969.03. For proof that the log haul did not comply with specifications, Martin relied on its summary which indicates they had some difficulty with it from the last of June to early October, 1962,

when a revision by Sutherlin "solved the problem" (Tr. 438, 648, Ex. 924-B). Initially, Martin complained the log haul was underpowered. However, no change was ever made in the power unit (which had been furnished by Martin), because the motor installed was found to be sufficient after the mechanism had a chance to be broken in (Tr. 1378, 1502), as McManama had advised.

Before McManama left the job, his superintendent, Howard Delahaye, had the log haul operating satisfactorily, having solved the initial problems by installing additional shrouding to keep the bark from fouling the chain (Tr. 1381, 1599). He received no further complaints (Tr. 1381). Delahaye also made a modification of the chain returns which were initially undersized (Tr. 1510, 1574). These returns were originally installed at Mr. Kemp's request and differed from McManama's plans (Tr. 1380). Mr. Delahaye (McManama's supervisor after Morrison left) testified that the log haul worked well when he left the job (Tr. 1576), as did Mr. McManama (Tr. 1428).

Exhibit 320 is a picture of the log haul as it was prior to June 20, 1962 (Tr. 1786). Exhibit 340 shows the revision accomplished by Sutherlin by October, 1962 (Tr. 1795). Exhibit 377 is a 1964 view of the same structure (Tr. 1800). Basically, all Sutherlin did was to relocate the spocket (Tr. 243-44). When Sutherlin was called in, Mr. Kemp was against the system he had initially approved (Ex. 209, 210, 211, 222 and 223). The fact that Sutherlin made a change in the drive system from the original system to an S-drive is no evidence that the drive as initially installed did not meet the specifications of the contract. All it proved was that Martin was not satisfied with it. Whether or not the amount of time spent in revis-

ing this portion of the structure was reasonable is a question that is immaterial until it is first decided whether the haul as established by McManama failed to meet the contract specification. Martin introduced no such evidence, and therefore it did not meet its burden with respect to this claim.

Included in this claim is work done by Martin's personnel on June 29, 1962, and July 7, 1962. McManama's crew did not leave the job until September 21, 1962 (Tr. 1524). If Martin's personnel did any work on the installation, it would have had to have been at McManama's request and not authorized by Soderhamn.

Mr. Halverson, when discussing the work done on the log haul section by Sutherlin, testified that he worked on the "skimmer conveyor" under the log haul (Tr. 411). This is a conveyor installed by McManama under direct purchase order from Martin and was not part of Soderhamn's contract. (See *infra*, 48) If corrective work was needed on this installation, it cannot be charged to Soderhamn. The only charges made by Sutherlin in connection with the log haul section is covered by Ex. 921 E, and this must include charges in connection with the "skimmer conveyor." How much of the charge was for that work would again be purely a matter of speculation.

Findings of Fact 3 A, B, C. Kickers, Kicker Shafts & Kicker Arms, R. 87 (Conclusion of Law 3, R. 94, line 17).

For claimed deficiencies in the kickers, kicker shafts and kicker arms on the barker outfeed the trial court allowed defendant $5,480.38. Mr. Kemp approved the detailed plans for this construction on October 12, 1961. He made additional specifications on

the original drawings (Ex. 206, 207, 208, 307, 334). Mr. Tozier admitted that there was no problem with the shafting until after it had been operating for a considerable length of time (Tr. 210, 266). The first complaint to Soderhamn was December 17, 1962 (Ex. 718). As far as the arms are concerned, Mr. Kemp approved mild steel, and it was initially installed by McManama in order that the shafting and bearings not be damaged by inexperienced operators (Tr. 1396). The kicker arms were considered expendable (Tr. 1452-54). The contract (Ex. 100, p. 26) provides in connection with the kicker arms:

> "Kickers to be fabricated of *structural steel* and mounted on 4-7/16 shafting carried in cast iron dolly boxes and powered by 12" air cylinders, Atlas, Cunningham, or equal." (Emphasis supplied)

That structural steel as specified in the contract is mild steel of the type installed is confirmed by Halverson of Sutherlin Machine Works (Tr. 367).

In the original installation of these kicker arms, practically any system could have been built. There was no contention that the kicker installation did not conform to the specifications of the contract. The $5,000 rebuilding job should not have been charged to Soderhamn in face of the fact that the system as built was approved by Martin's representative prior to its installation and was built as approved.

Martin's case on this point never attempted to show that the Sutherlin revision bore any relation to the criteria of the approved plan. Its case proceeded on a theory that it was entitled to build, at Soderhamn's cost, any system it could devise. There is no rule of law that permits such a measure of damage,

even if we were to assume for argument that McManama's (and hence Soderhamn's) responsibility went beyond building that which was specified in the plans and specifications approved by Martin. It is obvious that the drawings became contractual terms when they were approved by Soderhamn and Martin, and this is certainly the practical interpretation followed by the parties. *Lease* v. *Corvallis Sand & Gravel Co.*, 185 F.2d 570 (9th Cir. 1951).

Martin relied on eight Sutherlin invoices totaling \$5,392.25 in support of the major portion of this claim (Ex. 928-B, p. 2). Mr. Halverson at no time testified as to the amount of charges, if any, his company (Sutherlin) billed for work in this area. He testified the charges his company made for work done for Martin was covered in Ex. 921A through Ex. 921N. The invoices referred to in defendant's Ex. 928-B, p. 2, which was rejected (Tr. 670), are not included in these exhibits. Mr. Martin at no time testified as to the cost, if any, incurred in connection with fixing the kickers or kicker arms (Tr. 898-899), nor did he make any reference to the invoices. He only referred to "folder 3 ABCD" of Exhibit 929, which contains no Sutherlin invoices on this point. Mr. Martin did, however, make reference to time cards relied upon to support work done in this area by his personnel. The time cards reflected work done in May, June and July, 1962 (Tr. 1157), which was while McManama was still on the job.

In sum: There is no evidence that Soderhamn failed to perform its contract in this regard. To be sure, Soderhamn did exactly what the contract called for. Martin asked and allowed Sutherlin substantially to rework the installation (after it had been in use for quite some time) in accordance with its newly

developed ideas which were quite different from the contract requirements. The record does not contain evidence either that the work was necessary to complete the contract or, for that matter, evidence of what the work cost was as to the major part of the claimed damage.

Finding of Fact 3D. Transfer Deck (R. 88) and Finding of Fact 17. Walkways & Stairways (R. 93) (Conclusion of Law 4 (R. 94-95)).

Conclusion of Law 4 includes damages resulting from Findings of Fact 3D and 17, in the total amount of $6,464. In this part of the argument the two findings are treated together.

This might be called "the all-steel contention." It is certain that Martin decided upon an all steel structure. It is equally certain that it so decided after the contract was executed. After the contract was signed, Martin decided to change the wood frame of the chipper building to steel (Tr. 725) and to change the barker building from wood to steel (Tr. 1364). It also changed the wooden decks to steel after wood had been installed on the transfer deck (Tr. 1279). On November 28, 1961, Mr. Kemp insisted that four-inch *wooden* plank be put on the deck rather than three inch and so marked the plan (Ex. 217). If Martin, prior to the signing of the contract on July 21, 1961, (Ex. 100) decided upon an all-steel installation, as it now contends, it apparently failed to inform Mr. Kemp, as well as Soderhamn and McManama.

Martin considers its "all-steel contention" a question of construction of the contract. There was no *ambiguity* in the contract. The matter of the materials to be used for walkways and deckings simply is not mentioned. That wood was within the contemplation

of the parties is amply evidenced by the fact that Mr. Kemp approved four-inch wood decking as late as November 28, 1961. When wood was approved (Ex. 217), it became a matter of contract and any change would require consideration. Martin elected prior to the execution of the contract to use steel piling rather than wood piling. (See Statement of the Case, p. 3, *supra.*) But this adds nothing to their claim.

Mr. Kemp issued a change order to Soderhamn to substitute steel on the walkways and on the core chipper building and paid a $1,200 difference (Tr. 716). This was later claimed to be a mistake on Kemp's part. This is not the type of an error that could be made if the negotiations, of which Mr. Kemp attended all (Ex. 904, p. 8), were for all-steel structures. Mr. Kemp admitted that he did not understand the contract the same way Ray Martin did (Tr. 722). He later admitted that he did not get the information from the insurance carrier (i.e., that an all steel structure would obtain a better insurance rate) before the contract was signed; hence they had to make the change afterwards (Tr. 726). Mr. Morrison, McManama's first supervisor, stated wood was originally intended (Ex. 902, p. 37).

Before the contract was executed, McManama proposed to install the barker structure on wood piling. Martin switched to steel piling and the contract was amended to provide that the barker assembly "be mounted on steel piling, steel caps and with steel crossbracing" (Ex. 100, p. 27). The original proposed contract price was increased some $26,000 as a result of this change by Martin. At the time of trial Mr. Kemp explained what was meant by steel piling, steel caps and steel crossbracing. He testified that steel pilings were the steel beams which were driven into the

ground to support the structure. The steel caps were steel beams which were set on top of the piling and used to tie the piling together. The steel crossbracing were the beams used to crossbrace the steel piling. No contention could be made that the language "steel piling, steel caps, steel crossbracing" referred to decks or buildings which were to be constructed on top of the steel piling and crossbeams. Yet at the time of trial Mr. Martin contended that at the time they changed from wood piling to steel piling prior to the execution of the contract it was understood and agreed that the installation was to be "all steel." (Tr. 856) This change was dictated by reason of "insurance requirements" (Tr. 725-6, 856).

The facts are: After the contract was signed Mr. Kemp signed three separate change orders which had the effect of amending the contract to substitute steel for wood in various parts of the installation. The first of these was change order 7 (Ex. 107), approved by Mr. Kemp on November 10, 1961, pertaining to Phase I (core chipper), which provided in part as follows:

> "Additional cost of *steel building* and *steel flooring* around core chipper." (Emphasis supplied)

The second was change order 11 (Ex. 111), approved by Mr. Kemp on January 8, 1962, pertaining to Phase III (sawmill chipper) and provided as follows, in part:

> "Additional cost for *steel frame chipper building* structure and *steel deck*." (Emphasis supplied)

The third change order was 17 (Ex. 117), approved by Mr. Kemp on May 10, 1962, pertaining to Phase II (barker building), which provided in part as follows:

> "Steel debarker building in lieu of metal clad wood frame for contract."

Mr. Ray Martin personally initialed and approved change orders numbered 7 and 17, after they had been approved by Mr. Kemp.

McManama submitted to Mr. Kemp a detailed drawing reflecting the layout of the log transfer deck (Ex. 217). The drawing reflected the deck would be made of 3″ wood planking. Mr. Kemp, after noting on the drawing that the 3″ *wood planking* should be changed to 4″ *wood planking*, approved the drawing on January 28, 1962.

Mr. Kemp, when questioned concerning the reason for the change from wood to steel as provided for in change orders 7, 11 and 17 mentioned above, stated that it was due to "insurance requirements." When asked when the question of insurance requirements arose, Mr. Kemp admitted that it was after the contract was signed. His testimony on this point is as follows:

> "Q. Now why—there was a change from wood frame steel clad so far as the barker building was concerned and the core chipper building was concerned and that was done after the contract was signed; is that correct?
>
> A. (Mr. Kemp) Yes, sir.
>
> Q. And why was that done?
>
> A. That was done after—we did not hear from our insurance broker, who is located in Chicago.
>
> Q. I see.
>
> A. And when we got our information from our insurance broker relative to insurance costs, naturally it was changed so we could enjoy the

minimum cost on insurance for the same.

Q. But the idea of the requirements of the insurance company was a matter that came up after the contract was signed and you then changed—.

A. It was in the mill, but we did not receive the answer by the time that the contract was signed.

Q. So then you amended the contract to satisfy your insurance people?

A. Correct, sir." (Tr. 725-6).

In face of the foregoing documentary evidence and positive testimony of Mr. Kemp, Mr. Ray Martin took the position at the time of trial that the original contract provided for an "all-steel" installation. He took the position that Kemp in approving the change orders referred to above had made a mistake; in other words, he had improperly interpreted the contract. When questioned as to his explanation as to why he personally approved two of the change orders previously approved by Mr. Kemp, he attempted to explain it by saying that he had done so on instructions of his father to avoid embarrassing Mr. Kemp. The extent to which Mr. Ray Martin was willing to go in his role as an advocate to sustain his initial position on this issue is demonstrated by his testimony on cross-examination (Tr. 1069-1080). In reluctantly admitting that his initial story that he personally signed the change orders to avoid embarrassing Mr. Kemp was in error, he testified as follows:

"Q. Isn't it a fact, Mr. Martin, that the question of wood versus steel did not come up at all until sometime in the early part of '62 in connection with the barker construction?

A. This may very possibly be the case, sir. I know that these conversations did take place rel-

ative to the steel versus wood, and the dates it appears I'm confused on.

Q. Isn't it a fact that you actually approved the Change Order No. 7 not for the purpose of, you might say, covering up Kemp's mistake but before this discussion between yourself and your father ever occurred?

A. That would appear to be the case, yes, sir.

Q. And isn't it a fact that at that time no question had arose about wood versus steel and that you were in accord with Mr. Kemp, and the change order was appropriate to cover the difference between the cost of substituting steel for wood?

A. Well, sir, as of that time, I think that I would have to say yes, that I — that this matter hadn't come to my — that I was in error on the 26th when I initialled that, and that these discussions took place after the 28th of November. But they did take place.

Q. I see. But at the time that you signed on November 10th, 1961, and November 28th, 1961, you were of the opinion that change orders covering the difference in cost of wood and steel were appropriate?

A. The error hadn't come to my mind as of that time, sir." (Tr. 1080, 81).

It is evident from the testimony of both Mr. Kemp and Mr. Ray Martin that at the outset neither one understood or interpreted the contract to require "all steel." Like the performance bond, which Mr. Ray Martin admitted was not called for by the contract (Tr. 1065), the steel was something he wanted, although it admittedly was not called for by the contract. This is not just a matter of Mr. Martin's cred-

ibility as a witness. The fact is that his direct testimony was directly contradicted by all the evidence.

Finding of Fact 3E. Pits, R. 88 (Conclusion of Law 2, R. 93, line 31).

For pits built under the hog and surge bin and feeder plaintiff was awarded $1,833.10, even though they were not contemplated by the parties prior to the execution of the agreement and, of course, are nowhere mentioned in the contract. The need for these pits was created by the movement by Martin (subsequent to the execution of the contract) of the location of the hog. Mr. McManama testified (Tr. 1285) that Mr. Kemp moved the location away from the cleat building. He stated that the structure initially was to be installed immediately adjacent to the side of the cleat building, but Kemp moved it 16 to 20 feet toward the pond (Tr. 1290). Exhibits 316, 317, 318, 322 and 354 show the barker structure and its relation to the cleat building. Mr. McManama further testified (Tr. 1286) that Martin made a fill in the mill pond after the contract was signed and that the reason for the necessity of these pits was the fill (Ex. 595). The steel box pit was required because the machines that were placed in them had to be lowered (Tr. 1287). It was contemplated that these machines would have been above the pond water line. The basic drawing in existence prior to the signing of the contract (Ex. 122) supports this. It shows these items right next to the cleat building. In Tr. 1290-91, Mr. McManama explained how the hog was moved for insurance reasons, or to make clearance so that fork lifts could travel adjacent to the cleat building. The matter of moving this structure and the lowering of the Jeffrey hog arises again in this brief when we get

into the contentions concerning the hog conveyor (see *infra*, p. 73). All of that difficulty resulted from this move (Tr. 1458-59).

The pits involved in this finding were not required under the original plans and the contract. They were necessitated by changes made solely by and at the direction of Martin. The expense was charged to Martin as additional work not within the contract. Despite the facts, indeed without regard to the facts, the trial court charged this expense back to Soderhamn. Here, as so frequently elsewhere in the case, the finding and conclusion are nothing less than a rewriting of the contract to impose on Soderhamn an agreement it never made.

Finding of Fact 4. Sheer Aprons, R. 88 (Conclusion of Law 3, R. 94, line 18).

Martin claimed and was awarded $2,758.16 for installation of sheer aprons or plating on guides to take logs into the mill pond from the barker outfeed conveyor. Exhibits 300, 301, 321, 334, 336, 363 and 399A show the area of the debarker upon which these sheer aprons were installed. The contract and Exhibit 122 showed no such installation. The specifications for this particular portion of the transfer deck are contained in Exhibit 200, which was approved by Kemp on November 28, 1961, and Exhibit 201A, approved by Kemp on September 22, 1961. The skids, as shown in the drawing (Ex. 122), would only have been "knees" or I-beams without cover. After Martin decided there should be plating, McManama had suggested ¾″ plate for the sheer aprons and the decking and had made his bid on that basis. Mr. Kemp decided not to spend that much money on the plating, and *Mr. Kemp* therefore determined that ¼″ would

be adequate (Tr. 1462). Later on, Mr. Tozier of Sutherlin, in his revamping of the system, decided that the ¼″ originally purchased by Mr. Kemp was too light and he put on ¾″ plus an 8″ I-beam to tie up the several knees (Tr. 213). Tozier says the beams that were installed were all right, but the ¼″ plate was loose at the weld and was torn (Tr. 274). Mr. Martin thought the original ¼″ plating came as a gift from McManama and Company, a gift prompted by the fact that McManama, according to Martin, thought something should be put on there (Tr. 905). This was not the fact at all, as illustrated by the Martin purchase order (Tr. 1461). Mr. McManama testified: "This ¼″ plate was applied as a part of the Martin's direct purchase order to us, and it was not applied to prevent logs from damaging the components which you mention below but merely to join the fabricated steel knees which extend out from the outfeed conveyor itself" (Tr. 1461-62). Mr. McManama went on to explain that he had bid on heavier material (and had predicted that ¼″ plate would fail) but Mr. Kemp had rejected the suggestion. When asked about this transaction at the trial, Ray Martin said he was not aware that Mr. McManama had recommended to Mr. Kemp that heavier steel be put on the transfer deck or had quoted a price initially of some $6,800 to do the work (Tr. 1172).

It would appear, therefore, that the original contract called for only the knees to be installed (Ex. 122), or that upon approving the plan (Ex. 201) Mr. Kemp set the specification. That the knees as installed were in conformity with that drawing was not questioned. In fact, McManama at his own expense went beyond that specification and established other knees. Martin contracted with McManama to cover the knees

with the ¼″ plating (notwithstanding McManama's recommendation that ¾″ should be used). It is completely beyond reason that Martin should now recover damages from Soderhamn because the plating which they had ordered from McManama to cover these knees broke up under the pounding of the logs.

The evidence of damages on this claim is also confusing. Mr. Halverson, when testifying as to what his company did and what his charges were, made no reference to any invoices covering this work, and none are a part of Exhibit 921A through 921N, which Mr. Halverson identified as covering his work. Invoice D1141, which is a part of Exhibit 921A (see *supra*, p. 30), covers work done in installing sheer plates on the log dump and block dump but does not contain a breakdown. Ex. 921B contains reference to "Replacing Saw Deck Plates" (Invoice D1508). Again one is left to speculate as to what, if anything, was expended on this item.

Finding of Fact 5. Barker Refuse Conveyors, R. 89 (Conclusion of Law 2, R. 94, line 7)

This finding and the allowance of $4,736.96 can fairly be called fantastic. Cursory examination of the contract (Ex. 100) shows that it provides for three bark conveyors in the log barker system. At page 27 the contract describes these:

> "8. Bark conveyors: No. 1 Bark Conveyor to receive bark from the 60″ barker and transfer it to No. 2 bark conveyor, *as shown*, to be carried to the adjacent surge bin at the edge of the pond. No. 3 bark conveyor to pick up sawdust from under the gang chain saw operation and transfer it into this above conveyor, as shown. (Emphasis added.)

"These three conveyors to be constructed of 3/16 formed troughs with 12 ga. AR liner and return trough. Chain to be ¾ x 6 long link with Skookum type flights, approximately 5′ o.c. Drives to be 5 h.p., 7-12 h.p. and 3 h.p., respectively, * * *"

The only drawing that was in existence at the time that the contract was signed as Exhibit 122. Therefore, the reference "*as shown*" appearing in the first sentence above quoted must, of necessity, have referred to that drawing. That drawing clearly shows three bark conveyors and their length is thereon stated. Viewing the upper right quadrant of the exhibit, a reference is found to a barker conveyor 30' long being placed under the debarker. Under the saws the notation is for a 53′ conveyor. The third conveyor, running at right angles to these first two, at approximately the center of the upper right quadrant, is marked "Bark and sawdust conveyor, 80′ long." The bark conveyor receiving the bark from the 60″ barker was termed the No. 1 barker in the contract (Ex. 100, p. 27). The bark conveyor picking up the sawdust from under the gang chain saws was designated the No. 3 bark conveyor (Ex. 100, p. 27). The No. 1 and the No. 3 conveyors were to empty into the No. 2 conveyor which ran at right angles to No. 1 and No. 3. It was termed the No. 2 conveyor (Ex. 100, p. 27).

What Martin was permitted to recover was $4,736.96 for building three *additional* conveyors, one a 55′ conveyor that cost $1,980.30, and another a 51′-6″ conveyor that cost $2,360 (Tr. 1274-75). The third was a conveyor built by Martin (Tr. 660). That there was no misunderstanding about the number of conveyors to be provided under the contract is clear from the testimony of Mr. Hill, who stated without

qualification that they were not included in the contract or the drawing (Tr. 1648). Mr. Kemp admitted that that was true (Ex. 904, p. 106). In his deposition he also admitted (Ex. 904, p. 109) that the conveyors called for by the contract were installed, as well as other items not specifically included in the contract. McManama testified (Tr. 1288, 1292): "There are only three conveyors involved in the project." At this point he also described the difficulty that he encountered as a result of Martin's moving the barker structure away from the cleat building (Tr. 1290). This has previously been alluded to (supra, 44), and it will be covered in detail in discussing Finding of Fact 10, concerning the conveyor to the hog (*infra*, 73). It is obvious that there are no other bark conveyors shown or referred to in the contract (Tr. 1298).

Most of the work was done by McManama under direct purchase order from Martin. Here again Martin includes work done by its personnel and in support thereof uses time cards covering work done in December, 1961, and May, 1962 (Tr. 1183), long before McManama left the job, or, for that matter, long before the conveyors were installed. Mr. Martin testified that it was necessary to install additional conveyors to pick up bark and other refuse developed at the barker installation in order to keep it from filling up the log pond. His testimony was as follows:

> "Now this area in depth was from 8 to 18 feet, and I would say probably a good average of 12 feet deep, and it's filled solid. And it was filled solid before we could get a conveyor or an addition from this point to down—" (Tr. 909).

He went on to testify (Tr. 909-11) that these additional conveyors were installed by McManama on a purchase order from Martin to correct this situation.

The facts are it was physically impossible for the log pond referred to by Mr. Martin to have been filled up with bark and other refuse developed by the berker operation for the simple reason that the barker refuse conveyor which he referred to was installed by McManama in May, 1962 (Ex. 925, p. 2) and the barker installation did not go into operation until June 28, 1962 (Ex. 924 B).

The parties contracted for specific conveyors, of specific lengths, in specific places at a specific cost. The work was done in absolute conformity with the contract, except for a change necessitated by Martin (see infra 73). But Martin determined that more or larger conveyors were needed. It ordered them and got them. It is incredible that Soderhamn should be required to pay Martin for failure to perform something it never contracted to do. Again the court rewrote the contract to accord with Martin's afterthoughts.

Finding of Fact 6A. Shrouding, R. 89 (Conclusion of Law 3, R. 94, line 19).

(NOTE: The Conclusion of Law included an award for this finding as well as for Finding of Fact 6B, a total of $9,312.72, of which $1,917.06 was with respect to this finding.)

There is no doubt that the contract does not state how much shrouding should be applied to catch sawdust from the saws. Further, there were no approved plans showing shrouding. There is no question that the witness Tozier (of Sutherlin) was of the opinion that the shrouding provided was insufficient. Needless to say, Mr. Kemp and Mr. Martin shared his view. This claim may be called the "all bark and all

sawdust" claim. It is Martin's contention that 100% of all bark and sawdust created in this wood processing should find its way into the recovery conveyor (Tr. 1397). Actually Kemp wanted 110% (Tr. 1464). Mr. McManama explained that 90% recovery is considered good and the cost of the last 10% is fantastic (Tr. 1465). Mr. Delahaye had never seen any plant where 100% recovery was had. Neither had anybody else, except Mr. Kemp.

Mr. McManama testified that the amount of shrouding installed was that normally installed and was equal to that of the installations shown to Martin's representative prior to the execution of the contract (Tr. 1462-63, 1585). In fact, they installed more than at the Feather River and the Tahoe plants (Tr. 1397). At one point in the negotiations, Mr. Kemp stated that the additional shrouding they required would cost $125 (Tr. 1649, Ex. 686, item 13, Ex. 901, p. 93). Soderhamn offered to credit Martin with $150 after this statement was made, and that was refused (Ex. 901, p. 93).

In support of this claim Martin relied on the invoices of the Sutherlin Machine Company, No. 1508 and No. 1669, which form a part of its Exhibit 921B. Reference to these invoices will show that invoice 1508 included replacing the saw deck plates as well as hoppers under saws. If it is assumed that the hoppers under the saws and the shrouding claimed for are the same, certainly replacement of the saw deck is not a proper part of a claim for shrouding. The evidence was that Mr. Kemp had removed some of the "expandex" plate (which he had had installed by special purchase order to McManama), but defendant has abandoned its original claim that this cost is chargeable to Soderhamn. It should not be awarded

sub silentia anything for "expandex." As far as invoice 1669 is concerned, the work described there has to do with the conveyor hopper under the saw deck. There is nothing to indicate whether this is one of the conveyors that Martin had constructed by Sutherlin or was one of the conveyors installed pursuant to the contract.

There was confusion among the Martin personnel at the trial as to which invoices applied to which claims, if any. The result was a kind of shotgun approach in an effort to prove costs, which left the effect of the evidence to speculation. This claim is a prime example.

Finding of Fact 6B. Log Lifts, R. 89 (Conclusion of Law 3, R. 94, line 19).

This finding concerns log lifts on the barker structure. The award was for $7,395.66. The support for the contention lies in Sutherlin's invoices contained in Exhibit 921C and part of 921B. A cursory view of these invoices will show that they include completing the conveyors (B1144-A-2) and reinforcing the structure under the saw deck (D1144-B-1). The probabilities are that these have nothing to do with the log lifts, since in no sense is a log lift a conveyor under the saw deck. The invoice D-1323 has to do with reinforcing the saw deck frame and D-1680 is simply marked "gussets." The need for and reasonableness of this reinforcing work was thoroughly covered in the discussion of the Finding of Fact 1, concerning the welding of the barker structure. The registered engineers thoroughly discounted the need or necessity or the advisability of this additional work.

Defendant's evidence includes invoice D1877,

which covered "Patching Holes in Saw Deck & Sawdust Conveyor." There is no evidence of any holes in the saw deck or conveyor due to any fault or omission of Soderhamn. The steel saw deck was installed of ¼" steel on direct purchase order from Mr. Kemp to McManama. The exhibit also includes invoice D1144-A-2, which covers "Materials delivered to site to complete conveyor under saw deck." There is no evidence as to any defect in any conveyor constructed by Soderhamn under its contract. Martin constructed an additional conveyor under the saw deck (Tr. 1186). One can only speculate as to which conveyor this invoice refers to.

As far as the log lifts are concerned, it appears that the contract provided that each saw (there were four) should have one set of log lifts, a set being four individual pins (Tr. 1198-1201, Ex. 100, p. 11): "With each saw will be furnished one complete set of 25,000 lb. capacity cradle type log lifts, ..." Ray Martin testified that by mutual assent the cradle type was subsequently change dto the pin type (Tr. 1199). He testified that McManama did in fact install the four sets.

Mr. Wahl said four log lifts for four saws is adequate (Tr. 1727). He had seen many installations where that was all that was used (Tr. 1729). Mr. Martin had complained that when a log was lifted by the pin, sometimes in cutting through the end section of the log the end would tip down and break off some good material at the point of the cut being made, and hence he concluded he needed another log lift to hold up the end. Mr. McManama had explained that it wasn't necessary. McManama said the control of the lift allowed the lift to be stopped at any point before full extension of the pin, so that the end of the log

could be supported on the deck while the section next adjacent was cut, thus preventing the breaking. This is done in many of the mills, as Mr. Wahl testified (Tr. 1729). In any event, if Martin wanted the extra set, it was not contracted for and hence it had no right to recover the same from Soderhamn in this action.

Finding of Fact 6C. Sinker Deck Drive, R. 89 (Conclusion of Law 3, R. 94, line 21).

This $56 item is worth attention because it is a typical example of the way defendant read the contract. Exhibit 323 shows where this motor was initially installed. Exhibit 353 shows it as revised. The revision accomplished the desire of Martin not to have this drive unit exposed as much as it was previously. If Mr. Martin or Mr. Kemp had wanted it installed that way in the first place, it would have been. However, even Mr. Martin admitted that the location of the motor on the sinker deck was shown on the drawing which was submitted by McManama to Martin (Tr. 1207). If Mr. Kemp had wanted it done in any other manner, it could have been done so originally. However, Mr. Kemp, on November 28, 1961, approved the location plans submitted to him (Ex. 217, Ex. 904, p. 132). He was right there and watched it installed and made no objection to it (Tr. 700). Exhibits 217 and 218 revealed that the item was built as approved and any change is properly at Martin's expense.

Finding of Fact 6D. Saw Roof, R. 90 (Conclusion of Law 2, R. 93, line 32).

This award for $1,161 is for an elaborate steel shed or building, which was erected by McManama on

direct purchase order from Martin to cover the saws installed at the end of the transfer deck. This structure can be seen in its early skeletal conditions in Exhibit 324 and as completed in Exhibit 354. The contract did not provide for a roof over the saws (Ex. 100). At one time McManama bid to Martin to build a roof over the saw deck. It was not accepted (Ex. 561, 562). His bid was $1,161 and was never authorized or executed. There is absolutely no other evidence in the record about this expense. The claim was wholly unsubstantiated by the evidence and therefore must fail. Even if there had been evidence of the cost of this covering, it is clear that even Mr. Kemp admitted that it was not in the contract (Ex. 904, p. 123). Mr. Kornberg stated that most saws are not covered (Tr. 120).

Defendant recognized that the evidence does not support this finding. At the time of trial it relied upon an invoice from McManama in the sum of $2,475.00 for work done on a direct purchase order from Mr. Kemp plus $59.59 for work done by Martin (Tr. 921). This invoice included a 4′ extension to the saw deck which Mr. Martin attempted to charge to Soderhamn (R. 16, Tr. 921), but which has since been abandoned (See Ex. 561, in which Martin agreed to assume cost of extension (Tr. 1240)). There is nothing in the record, however, to establish what portion of the actual contract price paid McManama or work done by Martin's own personnel was attributable to the 3′ or 4′ extension and which to the roof. Again the evidence is speculative, even if the contract required a saw roof.

Finding of Fact 7. Hydraulic System, R. 90 (Conclusion of Law 3, R. 94, line 23).

For correcting supposed deficiencies in the hydraulic system, defendant was allowed $2,130.76, including $739.53 for lost oil. Irrespective of the merits of this claim, it is interesting to examine some of the evidence upon which defendant relies in support of the amount of this claim. Again the contents of Exhibit 929 were relied upon, including a Mobil Oil Company invoice (No. 161106) for oil, dated "5/2/-62." That date was more than five months before Sutherlin commenced its work in October 1962, and two months before the barker was operative. There is nothing else in the record to substantiate this claim, and it surely cannot be a part of the complaint Sutherlin corrected. Mr. Halverson testified about the defects that he found: "Well, the hydraulic piping was being subjected to an extreme amount of hammer, such as you might hear in water pipes that I imagine everyone has in that type of piping, and it was due primarily to heating condition and the fact that there was no allowance made for expansion of these pipes. And we corrected that by putting in a hose in critical areas that would allow the pipes to expand as the oil temperature rose" (Tr. 369). The Sutherlin Machine Works invoices D 1292 and D 1292-A, dated in October (Ex. 929) are for material and labor in the work: "Furnish & install hyd hose units to stop vibration breakage on pipes on Barker."

Mr. Kornberg admitted that there was some initial difficulty with the hydraulic system (Tr. 114). Mr. McManama testified that the difficulties were corrected while McManama's crew was on the job (Tr. 1391). He stated he received no further com-

plaints. Mr. Delahaye stated that after the first start-up there were some broken lines that he saw and he installed flexible hoses (Tr. 1579). Of course, there was no charge to Martin for this work. If Martin experienced trouble after McManama's withdrawal, it was incumbent upon Martin to call it to the attention of McManama or Soderhamn so effective measures might have been taken by them. No notice of any breach of warranty was given Soderhamn, and since this was not done, it is not a proper countercharge (repealed ORS 75.490, Sales Act). There was no tie-up of the evidence indicating that the work which required correction was caused by contract insufficiency. The basis of Martin's claim seems to be that since there were initial difficulties, it was entitled to repair subsequent difficulties without giving any notice to the contractor of intention to do so. Unless Martin intended initially to absorb the cost, such notice should have been given. In any event, there is no competent evidence that the work done was required because of incomplete installation of the specified work or poor workmanship or materials.

Finding of Fact 8. Debarker, R. 90 (Conclusion of Law 2, R. 93, line 30).

To a substantial degree this finding is at the heart of this lawsuit. It is evident that the trial court, by accepting defendant's proposed finding, adopted a very simple view of a complex issue—and without a serious review of the evidence. The finding is, first, that Soderhamn contracted to furnish and install a barker. Of that there can be absolutely no doubt, but the finding is that Soderhamn *failed to do so.* That is plainly, simply and absolutely false. The third element of the finding is that the debarker Soderhamn fur-

nished was "deficient and defective," and the fourth is that Soderhamn removed the barker and failed to supply another. Therefore, it is said, Martin is entitled to receive a credit *of the full price* under the contract of $81,500.

The theory of the finding is that Martin had a legal right to return the installed barker and receive full credit for its price. Whether that is legally correct depends upon a factual analysis which the trial court did not make, but it is critically important to take notice that Martin did *not* ask compensation for damages it might have suffered by reason of supposed defects. It asked for its money back, without any allowance for use of the machine for a period of 13 months.

Without any doubt at all the barker machine (pictured in Ex. 302) gave trouble to both Soderhamn and Martin. Soderhamn had never built a 60″ machine before (Tr. 77), and the Portland fabricator had difficulty keeping production on schedule (Ex. 437, 455). It was installed on June 28, 1962. Thereafter in attempted operation there were numerous difficulties relating to the hydraulic system in the barker, the electrical system, and necessary adjustments to the machine. Martin detailed its "down time" in Exhibit 924-B (which also includes problems not related to the barker machine (Tr. 1227)). In every instance Soderhamn undertook and made the necessary repairs and adjustments. Still and all the barker was working, by Martin's own figures, 69% of the time (Tr. 1226-27).

While all these problems considerably acerbated the relationship between the parties, they were not the ones claimed to give Martin the right to return

the machine. Beginning February 13, 1963, the barker ring bearing "froze." Between that date and May 17, 1963, there followed a series of repairs, replacements and failures until there had been a total of six bearing failures. The barking operation entailed conveying a log through a ring which carried numerous blades under tension. The ring rotated rapidly, and the knives pressed against the logs, cutting away the bark. The ring rode on 124 ball bearings mounted in a round cage consisting of four heavy wire races (see "Figure 1, T.R. Miles," in the drawings made by witnesses). The races were the parts that failed in service. On May 23, the barker was put back in operation after Soderhamn repaired it following the sixth failure. Martin said then that if the bearing failed again it would return the machine (Exs. 772, 776). There was no bearing trouble for more than two months, during which time the machine operated almost continuously.

On August 6, 1963, Kemp shut the barker down for the last time after finding metal shavings in the oil and hearing a "growling" noise. Martin demanded a new bearing assembly (Ex. 779), but not being satisfied with Soderhamn's reply (Ex. 780) notified Soderhamn to "pick up your barker" (Ex. 781). About November 17, Soderhamn took the barker away pursuant to a stipulation (Pretrial Order, § II. 9, R. 10) that the removal was "without prejudice to the rights and contentions to the parties in this action." (The stipulation was omitted from defendant's proposed Findings of Fact and Conclusions of Law, R. 86, line 20, which omission was objected to by plaintiff, R. 57, lines 5-8.) The barker was reconditioned and resold for $46,827.76 (R. 11); as reconditioned it incorporated larger rotor bearing races of the same design

(Tr. 76), which had become available for the first time after the sixth failure (Tr. 82) and had been offered to Martin at no cost (Tr. 1822-23). The only major difference in the new races was a reduced need for adjustment (Tr. 1822-24).

The crucial issue is whether there was in fact a seventh bearing unit failure. The sole evidence, with one exception, of a seventh bearing failure lies in the testimony of Mr. Kemp and his help that the machine was making a noise and that there were some metal filings found in the oil on the date of the alleged seventh failure. Mr. Kemp admitted that the rotor could be moved by hand after they had shut it down (Ex. 904, p. 97). When the barker was examined by Soderhamn's people after its return, they could find nothing wrong with it, and, especially, no source for metal filings (Tr. 170).

The other evidence offered was the testimony of Martin's expert, Mr. Czyzewski, who had made a metallurgical study of the six bearing assembly and the seventh (Ex. 922). But the most he could say, after an exhaustive study, was there was "an incipient break down . . ., that . . . could have operated for some time . . ." (Tr. 573).

Czyzewski's opinion was thoroughly discredited by Harold Belanger (Tr. 763-844). Mr. Belanger, whose business is bearings, unqualifiedly stated that there was no failure of the bearing (Tr. 767-781, 805, 841). He completely discounted Czyzewski's contention that the brown spots on the cages were an indication of failure. He termed them "Brinnelling" or "fretting corrosion" (Tr. 768). He stated that these brown spots occur only when the bearing is stationary (Tr. 773), and that the dents shown in the metallurgist's

photographs were not caused while the bearing was in operation (Tr. 774). He stated that the corrosion occurred after the machine was shut down (Tr. 778). (NOTE: Mr. Czyzewski did not know the barker had been stationary for four months before his study (Tr. 583-585). He said (Tr. 591-592) the corrosion was consistent with vibration of a stationary machine). Berlanger positively stated that the bearing was an over-design with ample safety factors for the application (Tr. 780). He stated that a crack in the race was not a fatigue crack but was caused by oscillation (Tr. 785). There was nothing on the bearings or the races which would indicate that any material had flaked off, so that the metal allegedly found in the oil, if there was any, could not have come from the bearing or the race (Tr. 786). It is apparent that a more qualified engineer than Belanger would be difficult to find in the United States. A graduate in mechanical engineering from the College of the City of New York in 1941, he worked for about seven years with New Departure Division of General Motors, the largest manufacturer of all types of power equipment, which of course requires the use of a great number of bearings. Following that he was the general bearing consultant for the Teck Bearing Company of Stratford, Connecticut. Since 1948 he has been a bearing consultant and bearing editor for a magazine called *Power Transmission Design*, of Cleveland, Ohio. He has done consulting work for practically every bearing company in the United States, has written catalogs for New Departure, for Taryington Company, and Minute Position Bearing Company. He has written many articles for *Machine Design* on specific bearing problems. He, of course, belongs to a national engineering society and the American Society of Mechanical Engineers (Tr. 763-65). Not only were Mr.

Belanger's credentials in order, his testimony was convincing—or should have been had the trial court considered it. The same should be said of the consistent testimony of plaintiff's witness Wahl (Tr. 1745-48).

Of major concern is the question of what caused the six failures which undoubtedly did occur. Mr. Belanger, considering all the evidence produced at the trial up to the point of his testimony, and considering the Czyzewski report and the history of the transaction as he detailed in his testimony, advanced two possibilities. One was that the bearing was subjected during shutdown periods to some form of vibration which set up the condition which is known as fretting corrosion. Then subsequent operation of the bearing caused feathering of the edges of the races and eventual deterioration (Tr. 824). He offered as another possibility that when the No. 1 bearing failed, the grooves which support the wires in the ring could have been damaged by the excess heat caused by the failure. He stated that if the rotor rings were not remachined after the first failure occurred (and they were not) and there had been a lot of damage done to them, this could have contributed very strongly to the failures that occurred thereafter (Tr. 826). If we accept the fact established by Mr. Belanger and Mr. Wahl that the seventh bearing installation did not fail in service, failures two, three, four, five and six can be attributed to the fact that the housing of the bearings was damaged during the first failure (Tr. 826). Also there is the possibility that tolerances were not properly maintained and that the lubricating oil was not consistently maintained on the bearing surfaces. Martin's employees contended to the contrary, but no maintenance record or tolerance record was produced by Martin which predated the first failure.

What of the first bearing then? What caused its failure? It should be remembered that the first *bearing* operated for 7½ months before the first failure (Tr. 162). Mr. Belanger's first hypothesis was that fretting corrosion, that is, oxidation caused by vibration, could have been a contributing cause of all of the six failures. That was the opinion of the bearing manufacturers (Ex. 773). It is certain that all bearings eventually wear out. It is also certain that Martin started the barker operation with inexperienced personnel. Neither side to this controversy is able to establish what caused the first bearing failure or the other five. Nonetheless, the engineering experts, Belanger and Wahl, stated the bearing was more than adequate for the purpose intended. There is no evidence that the bearing races were not adequately designed, only that they wore out, the first after 7½ months and the other five one after another. It seems apparent that Mr. Belanger's theory is the most convincing, i.e., that the first wore out in service and when it went it warped the casting, which was not remachined until after other bearings went out. After it was remachined there were no further bearing failures.

This machine cost $81,500. Its resale brought a net return of $46,828.86, which Soderhamn credited to Martin. Martin insists upon its right to credit also for the difference between the $46,828.86 figure and the price it paid of $81,500, or $34,671.14. Its theory is basically that the machine did not do the job because of the bearing failure, i.e., breach of warranty.

The contract for the sale of the barker was made before the adoption of the Uniform Commercial Code in Oregon. The buyer's remedies for breach of warranty are, therefore, controlled by the now repealed

ORS 75.690, which was section 69 of the Uniform Sales Act. That provision gives the buyer an *election* to do any *one* of the following:

A. Keep the unit and recoup his damages when sued for the price by the seller.

B. Accept the unit and sue for damages.

C. Reject the unit (if the property had not passed) and sue for damages.

D. Rescind and recover the price paid.

In pleading Martin took two contradictory positions. It asked for the recovery of the price (or, more accurately, the recovery of the price of another machine) (Pretrial Order § IV, Defendant's Contentions 8 (d), R. 17). It also sought to recover damages by reason of the alleged breach, e.g., lost profits (Pretrial Order § IV, Defendant's Contentions 19, R. 20-21). Although Martin introduced evidence in respect to both contentions at the trial, it apparently recognized that its damage claim was contrary to the Sales Act and it elected, judging by the proposed Findings of Fact and Conclusions of Law, to seek only the recovery of the price, although arguably some of its other contentions (see, e.g., R. 17, lines 11-17, R. 20, lines 20-28) seem to be claims for damages for breach of warranty.

In any event if the first six failures were breaches of warranty which Martin allowed Soderhamn to repair, and if thereafter Martin made use of the machine in its operations, it would seem that the property was deemed by the parties to have passed, according to their intention and because Martin accepted the barker by acting as owner (repealed ORS 75.-480). Martin could only rescind (as it now has chosen

to attempt to do) if its acceptance of the working machine after the sixth failure and repair had been on an assumption that Soderhamn had furnished assurance that the machine then conformed to the contract, and if the machine had thereafter failed. Martin had the burden to show that after its acceptance of the machine there was in fact a subsequent failure. See *Klinge* v. *Farris*, 128 Or. 142, 157, 268 P. 748, 273 P. 954 (1929).

Martin's right to refuse the machine, then, was dependent upon Martin's showing that the seventh bearing failed. The unrebutted evidence of Mr. Belanger and Mr. Wahl was that there was no failure. Mr. Kemp stated that the rotor could be moved by hand when he shut the machine down on its final day of operation (Ex. 904, p. 97). The engineers at Soderhamn had the same experience when it was received in their shop (Tr. 170). Soderhamn called Martin to advise it to make its personnel available to examine the machine because there was no appearance of failure. Martin instead sent Mr. Czyzewski to find a failure.

Martin was bound to retain the machine because they had accepted the previous bearing replacements, unless there was another failure. They continued to operate the machine. How much more was required to accept the machine? The contract did not require Soderhamn to furnish bearings for the machine forever. Conversely, Martin expected them to last longer than the periods of time occurring between the second, third, fourth, fifth and sixth failures. The defective parts were replaced without charge. The remachining apparently had solved the problem (probably created when the first bearing failed after 7½ months of service), considering that the barker operated on a

two shift basis continuously after the sixth replacement (Tr. 1229). Martin was not entitled to return the machine just because a growling was heard. It should be remembered that the new bearing which was operating satisfactorily in Nevada City, Californit, at the time of the trial, was offered to Martin on June 3, 1962, at no charge (Tr. 1822-23). Plaintiff's continued use of this machine precludes recovery on this claim.

At the time of trial defendant took the position it was entitled to damages for what it contended to be a defective barker, based upon what it would cost to purchase a 60″ Nicholson barker (approximately $97,000), less the credit allowed by Soderhamn on the resale. It abandoned this theory in favor of the difference between the purchase price of the Soderhamn barker, $81,500, and the resale credit, as though Soderhamn agreed to sell them a barker for $81,500 but failed to deliver. If in fact Soderhamn had failed to deliver the barker, that would be true. The fallacy of Martin's position is that Soderhamn delivered the barker. In fact, the barker was installed in Martin's plant and placed in operation on June 28, 1962. The barker was used by Martin from that date until August 5, 1963. During a good portion of this period it operated two 10-hour shifts per day. After repair of the sixth failure, the barker operated 971½ hours in production (Tr. 1229). The evidence submitted at the time of trial in support of the claim for "loss of chip revenue," now withdrawn, (Tr. 1021-1026) amply demonstrates the use made by Martin of the machine for over one year and the money made by Martin through its use. There is no rule of law or theory of damages which would sanction a buyer purchasing an $81,500 piece of equipment, using the

equipment in his business for over one year, reaping substantial profits from its use and then saying, "Give me my money back."

If the barker was defective and as a result Martin was entitled to damages, the damages could not exceed the cost of repairing the defect or the cost of the machine less a reasonable allowance for the value of the use made of the machine. There is no evidence to support an allowance of the full price as damages, even assuming it had made such an election.

Finding of Fact 8(a). Barker Removal, R. 90 (Conclusion of Law 5, R. 95, which includes Findings 8(a), (b), (c)).

This finding allows incidental expenses allegedly incurred ($2,666.56), because of the barker bearing difficulties. That this claim is wholly inconsistent with repealed ORS 75.690 and defendant's election has been pointed out under the last part of this argument. Logically, these expenses, even if properly documented and not barred by the statute could be assessed against Soderhamn only if it was proved that they were concurred by reason of contract deficiencies for which Soderhamn was responsible. The only testimony in support of this claim was by Mr. Martin, based on Exhibit 929:

> "Q. Do you have a record, Mr. Martin, of the expense to which the Martin Brothers went in connection with this installation and operation and removal of the roller from the barker structure for repairs?
>
> A. Yes, sir.
>
> Q. I am referring, Mr. Martin, to your Folder No. 8-A.
>
> A. Yes, sir, I have it. 'Debarker Repair.'
>
> Q. Now, does that folder contain the time

cards for labor expended by Martin Bros. in connection with the removal and reinstallation and removal again of the rotor and of the building and the other items that were necessary in connection with the failures of the debarker?

A. Yes, sir.

Q. And what is the total of that down time?

A. 2,000-2,656.56.

Q. Could you state whether that is a reasonable charge for the time and labor involved?

A. Yes, sir." (Tr. 950)

All that folder contains is 27 time cards and two adding machine tapes. Exhibit 931, about which Mr. Martin did not testify, contains two invoices (B-818-97, 1899) from Sutherlin for charges in connection with "lifting the barker ring," but there is no testimony tying these invoices to any bearing failure. Mr. Martin had no personal knowledge on the subject (Tr. 1137-39; 1150-56). In this state of the record, there was a simple failure of proof.

Finding of Fact 8(b). Barker Building, R. 91 (Conclusion of Law 5).

Martin was awarded $8,496.82 for rebuilding of the structure to accommodate its new Nicholson 72″ barker. Here again the only evidence is Exhibit 929 and the testimony of Mr. Martin. Also, here again, the exhibit (consisting of two folders) contains a pile of time cards, some unexplained invoices and adding machine tapes. Mr. Martin's testimony is unilluminating:

"Q. . . . And was it a big debarker?

A. Yes, sir, it was a 75″ barker.

Q. And what did you pay for that?

A. $132,000.

Q. Mr. Martin, in installing—in removing the Soderhamn debarker from the barker structure and in placing another barker on the barker structure, did Martin Bros. necessarily go to some expense in connection with the removal of the building and the reinstalling of the building?

A. Yes, sir.

Q. And how was that expense incurred, if you might tell us?

A. They had to take out—they had to take off the entire roof structure and two complete walls and the part of another wall and then they had to rebuild the building.

Q. Have you before you in Exhibit 929, which contains the details of the amounts expended by the Martin Bros. in connection with that particular item of work?

A. Yes, sir.

Q. Can you state from those records an amount involved in that work?

A. Yes, sir. If you will give me just a second here I'll get these back in order so that we don't mess them up. (pause) The total amount of the barker building in removing the barker building and rebuilding and replacing it was \$8,496.82." (Tr. 963-964)

Martin included the cost of constructing or reconstructing a building to house a 72″, \$132,000 barker it purchased from Nicholson to replace the Soderhamn 60″ debarker (Tr. 954, 963). A 60″ replacement barker was available from Nicholson (Tr. 960). Martin elected to acquire a 72″ machine, which was bigger and heavier than the 60″ machine (Tr. 1232). To house the 72″ barker it was necessary to increase the size of the barker building (Tr. 1231-32). Even

if Soderhamn is chargeable with the cost of restoring a building over a replacement barker, (which is contrary to the Sales Act) certainly there is no basis for assessing the additional costs that necessarily had to be incurred in constructing a *bigger* building to house a *bigger* barker. No evidence shows how much of the cost was allocable to the larger building. The amount chargeable to Soderhamn is purely speculative. Moreover the whole expense was due to Martin's decision to remove the barker and return it to Soderhamn. If there was in fact no seventh bearing failure, then there was no right to return. Hence, the building need not have been destroyed and rebuilt.

Finding of Fact 8(c). Labor furnished by defendant, R. 91 (Conclusion of Law 5).

Again the only evidence is Mr. Ray Martin's testimony, and as usual he had no personal knowledge of where or when this work was done (Tr. 1216, 1236, 1237). He was relying on time cards covering work done for McManama in May, June and July, 1962 (Tr. 1236-37), before McManama left the project.

It was anticipated by the parties when the contract was executed that Martin's employees would participate in and receive instructions during start-up. Of necessity Martin had to have personnel engaged in connection with the start-up of the barker and other parts of the installation in order to acquaint themselves with the equipment, how to operate it and maintain it. This cannot be a charge against Soderhamn and ought not to have been allowed.

Finding of Fact 9. Console, R. 91 (Conclusion of Law 3, R. 94, line 24).

The trial court awarded $422.90 for expenses in relocating the barker operator's console. At the trial no one would accept responsibility for the original location. Mr. Hill, Soderhamn's engineer, stated that it was not located where he wanted it, but where Mr. Oiler and other employees of Martin insisted:

> "I was at a meeting in Mr. Kemp's office sometime prior to the actual location of the console when we had a discussion and as— . . . . As I recall, we discussed this, not necessarily with Dick but with other people who were in his office at that time, and we made a tentative location on a plan as to where we felt the console should be. This is not where it ended up initially." (Tr. 1636-37)

At this meeting were Ron Oiler (Martin), Ronnie Copeland (Martin), Ellis Duncan of Dixie Controller, George Thoming of Soderhamn, and Dick Kemp (Tr. 1637). At that time an "X" was placed on a drawing indicating where the console was to go.

Mr. Delahaye said there was a conference held on the location, and present were Kemp, Morrison, Delahaye, Oiler, and gentlemen from other concerns (Tr. 1586). He stated that Kemp said "Put it right there," and that is where it went (Tr. 1586). Mr. Delahaye stated that if he had had the say he would have put it on the outfeed instead of the infeed (Tr. 1613). Mr. Kemp admitted at the trial that there was ample discussion of its location prior to the installation (Tr. 677-78). He stated that one of the prints showed it on the opposite side of where it was installed. It is obvious that the console could have been located any-

where he wanted it, and it is also obvious that he had the right and did so direct. While he did not admit it, the evidence is that he did direct its initial installation or at the very least participate in the decision. Therefore, the cost of removing the same would be the responsibility of his employer.

Mr. Morrison of the McManama firm did not like its initial location either (Ex. 902, p. 27). He stated it was put there by mutual agreement. Although he used the term "mutual agreement," he stated that he would not personally have placed it there. He also stated he would not put the finger on anybody, indicating he would not say who spotted the exact location (Ex. 902, p. 27). He did say (Ex. 902, pp. 54-55) that Kemp and Copeland said that the location would be satisfactory. Mr. Oiler, of Martin's staff, quoted Hill as saying that he wanted it in the corner and elevated as it was later changed (Ex. 906, p. 89), but it was not put in that way. He stated that he asked about this location and he was told that it was put where Kemp wanted it. Mr. Kemp's feeble explanation (Ex. 904, p. 99) was that he could not say who designated the location and that he did not know where he wanted it. At page 102 of his deposition (Ex. 904) he said he did not object to the placement.

Again defendant relies on Mr. Martin to support this claim. He did so in the usual manner. He relied on Ex. 929, which had some figures but they did not add up (Tr. 967). There is a reference to the console in Ex. 921G: it covers glass. Invoice D1141, a part of Ex. 921A, refers to "constructed window around barker operator." There is no reference to any change in the location of the console which appears to be the basis of defendant's claim.

No one disagrees the console had to be moved. But

the trial court failed to note the evidence that showed who was responsible for the defect. If Martin's Kemp directed its position, or agreed to it, relocation was not Soderhamn's responsibility.

Finding of Fact 10. Conveyor to Hog, R. 91 (Conclusion of Law 3, R. 94, line 25).

Previous reference has been made to the barker refuse conveyor system and to the fact that additional discussion would be had concerning conveyor No. 2, which was the conveyor to the hog (supra, 45). This was the conveyor that ran at right angles to the bark conveyor (No. 1) which ran under the barker and the saw conveyor (No. 3) which ran under the cut-off saws (Ex. 122). The complaint was that the conveyor to carry bark and sawdust to the hog installed by McManama was not capable of sustained, successful operation. The contract for this No. 2 bark conveyor was for an 80′ conveyor (Ex. 122, p. 27). The drawings submitted for this conveyor for approval of Martin Bros. (Ex. 271) was for a 67′ conveyor, a "straight shot" conveyor.

Mr. McNamana explained the difficulty he faced. Martin's movement of the Jeffrey hog away from the cleat building accounted for the reduction in length of this conveyor from 80′ to 67′ and required raising the elevation of one end of the conveyor and lowering the other so as to meet conveyor No. 1, conveyor No. 3 and the hog. He was dealing now with the 67′ conveyor and not an 80′ conveyor. He had to be under conveyors Nos. 1 and 3 a sufficient distance to allow bark to drop in, and at the same time he had to be above the hog to allow the bark to drop out and into the hog (Tr. 1399-1400). The problems Martin had with this conveyor were caused by jamming the Jef-

frey hog up against the barker structure. If this change had not been made in the first place, there would not have been any trouble. Martin did not consult with McManama or Soderhamn before making the change.

Exhibits 306, 307 and 308 show this conveyor as initially installed. Exhibit 309 shows the Jeffrey hog. Exhibit 313 shows the lack of success of one of the revisions Sutherlin attempted in 1963 (Tr. 1790). Exhibit 310 is a similar illustration of this, and Exhibits 311 and 312 also show hang-ups with the Sutherlin revision (Tr. 1791). Exhibit 332 shows the road, as does Exhibit 336. Where the flat bed truck is located on the road (Ex. 332, 336) is the area where the 13 feet were taken from the length of this original conveyor. The hang-up Martin complained of, at the point where the third bark conveyor emptied into the second bark conveyor, was also caused by the same factor; namely, change in elevation. There would have been no hang-up if adequate drop could have been established below the end of the third conveyor.

Exhibit 122, the drawing in existence at the time the contract was signed, shows that the pond was immediately adjacent to this cleat building prior to the fill being completed. It also shows that the hog was to have been located within 16′ of the closest adjacent line of the cleat building. Exhibit 333 shows the original installation (Tr. 1792). Exhibit 348 shows the revised hog conveyor, and Exhibit 349 shows the debris accumulated under the revised system. See also Exhibits 343 and 344 (Tr. 796). Exhibit 352 shows the roll-back experienced by the Sutherlin system, and Exhibit 350 shows the method of feeding the bark to the belt which was Sutherlin's second system. Exhibit 345 shows a hang-up in the system as modified

in mid-1963 (Tr. 1797). Exhibit 347 shows how the hog had to be located right behind the saws. Compare this to Exhibit 122, which shows the hog considerably behind the location of the saws. Exhibit 351 shows the hog conveyor and Exhibit 365 shows the belt to the hog.

It is obvious that the trial and erorr system followed by Mr. Kemp and Sutherlin in their attempts to rectify some of the problems with the McManama installation was extremely costly and unreasonable. Its unreasonableness was testified to by Mr. Kintz who said a $3,000 to $5,000 cost would have been enough to do what Sutherlin did (Tr. 1778). Another witness, Mr. Wahl, was of the opinion that a conveyor such as was created by Sutherlin could be done for $5,970 (Tr. 1688). It was apparent in the testimony that the cost of conveyors of this type is in the area of $36.00 to $46.00 per foot (Tr. 1299-1303). This is the price that McManama charged Soderhamn for the first three conveyors and the price McManama charged Martin for the two additional conveyors it purchased (Tr. 1274).

Arthur Kintz, an engineer, whose business it is to compute the cost of and build this type of apparatus, said the costs submitted by Martin in this matter were entirely unreasonable (Tr. 1765-66). He was aware that they did their work on the weekends and at night, and said they were still unreasonable (Tr. 1777). He stated the costs under the usual conditions were $3,000 to $5,000 (Tr. 1778). The other engineer, Wahl, stated that the costs submitted by Martin were not reasonable and should have been in the area of $6,000. He said the original system as designed (i.e., with a spring tightener) was a satisfactory design

(Tr. 1688). He also pointed out that his $6,000 figure was for a new 85′ conveyor (Tr. 1725). In stating that the cost was excessive, Mr. Wahl took into consideration the time the work had to be done, considering overtime, and he felt that $6,000 would be more than adequate (Tr. 1726-27).

Mr. Tozier, of the Sutherlin Company, stated that when he inspected the operation of McManama's conveyor, after it had been in use for some time, the angle of it was not too steep and that it was not giving roll-back (Tr. 298). He stated also that when Sutherlin cut the McManama conveyor and put in their belt design they had trouble with it (Tr. 299). Actually the exhibits indicate how much trouble they had with their second design. Much of the cost attributed to this claim was for correcting Sutherlin's revisions. All Sutherlin did with respect to the McManama conveyor was to cut one section out and rearrange and change the drive sprockets and the drums and add an S-drive, as opposed to the spring tightener which had been designed, approved and installed (Tr. 297).

One of the excuses offered for having to revise the McManama conveyor was that the chain had broken and had been fed into the hog. While it was admitted by Tozier that there was no damage to the hog (Tr. 295), he stated that it did bend the chain somewhat. The hog was also provided with a metal "trap" to prevent hog damage (Ex. 100, p. 13). Halverson admitted that chains going into the hog are a common sawmill experience (Tr. 418). Halverson, (Sutherlin) who had to redesign his own modification system, stated that he was hampered by the space allotments the same as McManama (Tr. 419). He also had to exceed the recommended conveyor angles (Tr. 418). He also had the same result (Tr. 418-19).

The most that could be wrung out of Mr. Kemp was that the barker was moved 8 inches (Tr. 704). He was quite vague and did not recall moving the hog some 20 feet. He answered in the same manner in which he answered the question about the location of the console (supra, 71-72). His recollection was particularly cloudy in these two areas. He did remember, however, that Sutherlin had trouble with the hog conveyor modification it made (Tr. 739).

It is apparent Martin was responsible for the creation of the situation which made engineering a satisfactory system difficult, if not impossible. Again, the reasons may have been sufficient for changing the location of the structure, but the change was not contemplated by the parties at the time the contract was bid. The evidence does not indicate that the conveyor as built by McManama was not as specified. The evidence is rather that Martin did not like it. After Sutherlin made the revision Martin did not like that, either. Ray Martin finally realized that with the space limitation problem they would have to accept less than a perfect system. The only alternative would have been to move the Jeffrey hog back again toward the cleat building (and thus obstruct the road). Apparently it was easier for Ray Martin to say that the Sutherlin revision was working satisfactorily with just *the normal maintenance* (Tr. 1244) than report to the Board of Directors that they had spent $14,000 on *two* revisions which didn't work.

The evidence on what was done and why in connection with this claim is likewise confusing. The record is clear that Sutherlin modified McManama's original installation. It is also clear that Sutherlin had trouble with its own modification and had to make additional changes. We are left again to speculate

how much is included in Martin's claim on this item for costs incurred in correcting Sutherlin's mistakes, as opposed to correcting McManama's alleged mistake. One thing is certain: it is difficult to believe that Sutherlin could have expended in excess of $14,000 in labor and material to modify a conveyor which at the outside could have been built new at a cost of $3,000 to $6,000. It is even more difficult to believe that Martin would pay such charges without questioning the price. In any event, the evidence is clear that Martin made no effort to mitigate any damage, even though Soderhamn's evidence showed mitigation was possible. *Enco* v. *Russell*, 210 Or. 324, 339, 331 P.2d 373 (1957).

There was no specific evidence to support damages on this item. Martin testified to the cost (Tr. 971). As usual, he was relying on Ex. 929, but that exhibit contained no proper evidence (see 96, infra). Mr. Halverson testified he would have no idea what he charged to modify the hog conveyor without looking at the record (Tr. 412). He had previously testified that Ex. 921F contained his charges on the hog conveyor (Tr. 348). He was in error on this point. Ex. 921F, though labeled "Hog Conveyor," totaled only $1,737.90. It included three invoices D1394, D1432 and D1432A, which on their face appear to cover work done on "Bark refuse conveyor under log haul," a different conveyor.

Finding of Fact 12. Horizontal Chipper Feed System, R. 92 (Conclusion of Law 3, R. 94, line 29).

The horizontal chipper system was on the other side of the sawmill from the units previously discussed. Exhibit 371 shows the "shaker roll" which was a component of the feed system. Exhibit 399-J

shows a similar shaker setup at the Hogan Lumber Company (Tr. 1810). The complaint was that the shaker roll as designed allowed material to fall through which should not have. As Mr. McManama explained, the question was "what materials should drop through and what shouldn't" (Tr. 1368). Mr. McManama had undertaken at his own expense to move the rollers closer together and had built a weighted gate at the junction of the shaker roll and the infeeding conveyor (Tr. 1368). But in the atmosphere of hostility existing at the time that this system was revised, it was deemed to be unsatisfactory also (Tr. 1367-75). This claim by Martin might be called the "all automatic" complaint. It was Kemp's theory that this part of the plant should operate without any human hands. This theory, of course, developed long after the signing of the contract. Testimony of an experienced sawmill man was that a man is expected to oversee these types of operation (Tr. 1481-82). Mr. Kintz, a registered engineer, said this type of operation needs an operator (Tr. 1757-59). Mr. Wahl was of the same opinion. Even Ray Martin admitted a man was to check it from time to time (Tr. 985).

On the question of how much should go through the shaker roll and how much should fall through and be conveyed off to the waste burner, Mr. Wahl stated that when quality chips are sought, sawdust, "pin chips" and "longs" are bad. He says the whole question had to do with money, quality, quantity and cost of design (Tr. 1668). The industry tries to avoid small blocks from going through the chipper because they sliver (Tr. 1671). He also noted that a shaker roll should be capable of getting rid of tramp steel (which would certainly damage the chipper if allowed

to pass over the shaker roll), short blocks and other refuse. He also stated that the longs, if allowed to be made by the chipper (i.e., if small blocks went to the chipper), would foul up the screening process (Tr. 1706) and could plug up the chipper (Tr. 1707). Mr. McManama stated that there were no unresolved complaints made after his crew left the job with respect to this portion of the work (Tr. 1391).

The shaker roll section was to consist of "a motorized shaker roll section to be furnished and installed to receive chippable slabs and edgings from the main sawmill refuse conveyor and transport them onto a chipper infeed belt conveyor. This shaker roll section to consist of heavy steel rolls arranged to agitate the chippable materal passing over it to shake out the sawdust and *small blocks* into existing refuse conveyor below while chippable material passes on into the infeed conveyor belt" (Ex. 100, p. 28, emphasis supplied). Nowhere in the contract is the term "chippable material" defined, but the preceding does state that the purpose of the shaker roll is to shake out the small blocks and sawdust.

It should be noticed that the system as engineered by McManama operated for one year before the fire which destroyed the mill in May, 1963. It should also be noticed that the shaker roll details were reduced to the status of plans and specifications and were approved by Mr. Kemp on December 20, 1961 (Ex. 236). There is no contention that the shaker roll was not built in accordance with the plans and specifications. Furthermore, McManama improved the installation after it was installed (Tr. 1368).

This claim was related to the sawmill chipper for which defendant asked $18,035 (Pretrial Order § IV,

Defendant's Contentions 13, R. 19) for a new chipper and $2,900.05 (Pretrial Order § IV, Defendant's Contentions 12-A, R. 18) for a slasher saw and a conveyor, both of which have been withdrawn since the trial.

The basic problem was the loss of what defendant called "chippable material" at the point where the main sawmill conveyor (a part of the original sawmill installation) joined the shaker roll installed by McManama. The trouble complained of was caused by the fact that the "flights" or metal cleats on the original chain on the sawmill conveyor required a sizable clearance between the head drum of the "old" sawmill conveyor and the shaker roll to permit the "flights" or metal cleats to clear the rolls as the chain turned on its drum (Tr. 1350-1354). After McManama installed his shaker roll and Mr. Kemp complained, he attempted to correct the loss of material, by inserting a "flapper gate," but that resulted in a hang-up (Tr. 1368). The fact remains that the problem was the clearance required by reason of the type of chain used on the old, original, main sawmill conveyor.

What did Sutherlin basically do to correct the situation? It cut the old main sawmill conveyor back some 30 feet (Tr. 680, 977) and substituted a belt conveyor for that portion. The belt conveyor, of course, contained no flights or metal cleats and therefore enabled Sutherlin to place the head of the new belt conveyor up flush to the shaker roll and thereby minimize the loss of any material at this juncture. McManama had previously suggested that the problem could be corrected at this point if Martin was willing to replace its main sawmill conveyor chain with a different type, but Martin refused to assume the cost

(Tr. 1372-73). Soderhamn had no obligation under the contract to install slasher saws, conveyors or other installations beyond the start of the shaker roll. Notwithstanding this, the trial court would charge Soderhamn with the cost of cutting back the old sawmill conveyor 30 feet and replacing it with a belt conveyor in order to satisfy Mr. Kemp's demand for 100% recovery of chippable material without the need of any manpower to supervise the operation. How much of the costs claimed by defendant on this item is attributable to the work done in replacing a portion of the main sawmill conveyor with a belt conveyor is again purely a matter of speculation.

To add to the confusion, Mr. Halverson testified that the work his company did in connection with the modification of this area totaled some $8,887.32 and was set forth in Ex. 921L (Tr. 348). Mr. Halverson's testimony was in error. Three out of the seven invoices included in Ex. 921L by Sutherlin to support costs incurred for modifying the horizontal sawmill chipper are *totally* unrelated to the problem (See invoices D1785, D1871-A, D2135). If Mr. Halverson did not know what he did or where, Mr. Martin certainly did not do much to clarify the matter for the record (Tr. 979-980). There is no question the record is in a state of confusion and placed the court in a position where all it could do was speculate.

Finding of Fact 14. Roof over Belt, R. 92 (Conclusion of Law 2, R. 94, line 2).

This item had to do with a conveyor roof which cost $558.10. Mr. McManama (Ex. 901, pp. 77-78) said this roof was not necessary. Mr. Kemp (Ex. 904, pp. 46-48) said there is nothing in the contract about it, and he did not say anything to McManama about it.

The contract (Ex. 100, p. 29) states that the chip conveyor was to receive the chips from the cyclone and to transport them 80 feet to the 30-unit surge bin. This conveyor was to consist of an 18″ belt carried in troughs and powered by 3 h.p. motors and a shaft reducer. Nothing stated that this conveyor should be airtight, watertight or anything of the kind. The plans for this conveyor were approved by Mr. Kemp on October 18, 1961 (Ex. 248, 249). The plans and specifications as approved do not show any roof. It is therefore submitted that this claim has no basis.

Mr. Halverson testified to the amount of this claim as covered by Ex. 921L. It was all performed on overtime—49½ hours at $7.00 per hour. There is no evidence of any emergency warranting this excessive charge. A most important point on this claim is that Martin never mentioned to Soderhamn or McManama that a roof was wanted or needed. It was not in the contract. Martin simply went ahead in April, 1963, after this lawsuit was instituted (one year and four months after the conveyor went into operation), had the work done and then asked Soderhamn to pay for it. It is hardly reasonable and certainly does not establish any emergency warranting payment of overtime.

Finding of Fact 15. Core-Veneer Blower System, R. 92 (Conclusion of Law 3, R. 94, line 27).

There were three separate pneumatic systems installed under this contract. One conveyed bark from the Jeffrey hog to a fuel disposal plant and another conveyed the chips from the chip screen and control center to railroad cars at a new siding which was completed. Martin conceded that these last two described systems operated satisfactorily. They were built, of

course, by the same people who built the one being complained of: Rader Pneumatics. The system complained of is known as the double injection system designed to convey the chips from the core chipper, which was installed under the contract, and from an existing veneer chipper to the chip control center. The contract unmistakably calls for the installation of a pneumatic system which would so operate as to convey the chips originating at the core chipper and the chips originating at the veneer chipper to the chip control center. The system was engineered and designed by Rader Pneumatics and installed by McManama, both as subcontractors of Soderhamn. The system *as operated* experienced plugging in the line. *But* there was no evidence that the double injection system was troublesome as a result of the installation. Nothing could be further from the truth. It was the position of Mr. Glassy (Tr. 1533-35, 1543, 1567) and the other technicians of the Rader company that the double injection system was capable of, and in fact did, handle the amount of material that it was designed to handle when it was operated properly. The information upon which Rader's people developed their design was given to them by Mr. Kemp. They were skeptical of his figures, and so they overdesigned it (Tr. 1543). It was their position that the trouble that Martin experienced was from overloading the system, not from any problems of design or installation (Tr. 1540-42).

It is apparent that the plugging problem on the blower system was not raised until the lawsuit was filed (Tr. 127-28, Ex. 678, Tr. 170-72). It is also apparent that at the meetings preceding the execution of the contract there were discussions between Mr. Keating of Rader Pneumatics, Mr. Kemp, Mr. Thom-

ing of Soderhamn, and Mr. McManama, wherein the subcontractors were advised of the amount of chips that were expected to be produced at the green end and at the veneer plant (Tr. 1339). Rader was to size this system to the mill according to the log scale production, veneer production and the sawmill production. All of this information was supplied by Mr. Kemp (Tr. 1339). As the system was originally operated, it had difficulty because Martin was storing cores instead of putting them into the system as they developed (Tr. 1365). Mr. Glassy observed this (Tr. 1531). Although Mr. Glassy attempted to correct this situation, which resulted because of the mishandling by Martin's crew, he was faced with the problem of Martin's crew changing the settings that he put on the machinery (Tr. 1537). Eventually he got Martin's Mr. Copeland to supervise this and to keep unauthorized personnel from tampering with it. Mr. Glassy made it very clear that the problems were caused by the overloading by failing to put the cores into the system as they were developed (Tr. 1541). Mr. Glassy stated that the installation exceeded the contract specifications. He said that the proposals he provided in 1963 (Ex. 818) included *increasing the capacity of the system to accommodate a new chipper*, which was to be installed to pick up the roundup (Tr. 1545-6, 1564). Mr. Glassy also stated that it was absolutely indifferent whether they used two pipes or the double injection system (Tr. 1566-67). Mr. Cheek, who made the initial design of this system for Rader (and who designed Martin's 6″ veneer blower which had operated nine years without trouble (Tr. 1863)) stated that the 6″ pipe size was used frequently. He stated that the design of this double injection was to take six units per hour and that Kemp gave him the

data on the material production from which this was developed (Tr. 1867). He said that Kemp was talking about six units in 1961 and ten units in 1963, when Rader was asked for a further proposal which became Ex. 818 (Tr. 1869). He said Kemp told him 24 units per 24 hours from the veneer chipper and 30 units per 24 hours from the core chipper, or a total of 50 units per 24 hours. Cheek said they were skeptical, and so they put in what Kemp said, the 50, and then they designed it for 144. That was their safety factor! The proposal they made, which became Exhibit 818, was not for correcting the 1961 installation but was under new ground rules, he said (Tr. 1873). When asked about the cause of the plugups, Mr. Kemp became reluctant again:

> "Not being an engineer, I am reluctant to answer that question." (Tr. 690).

A little later he said:

> "The Rader Pneumatic people, very good installers, were called in." (Tr. 690).

Mr. Martin acknowledged that Rader was recognized as a leader in the field (Tr. 999).

Martin had accepted this core chipping system, including the pneumatic conveying system from the core chipper, in March, 1962, as Mr. Kemp testified (Tr. 708). He denied designating the location of the blow pipe and the specification on the bends for this system (Tr. 710). He could not recall any discussion of the location of the system with the Rader people before Soderhamn got into the deal. He did say (Tr. 713) that at the start-up he followed Rader's instructions and had no trouble, and that he made no complaint to Soderhamn about its operation until after Soderhamn had filed this lawsuit. Again, he added,

the Rader people were good designers and good engineers (Tr. 714). Mr. Martin, when he testified, stated he did not know what the trouble was, that he did not say the pipe was too small. He also admitted that he had accepted that part of the system (Tr. 869-70).

The evidence introduced by the Martin Bros. in support of this claim is wholly unconvincing. It was fully rebutted. As a matter of law, this claim should not be allowed.

But even assuming defendant was correct in its contention that the pneumatic chip conveying system designed by Rader Pneumatics was defective, it is obvious that the amount paid Archer to install a new system covered a larger system to handle more material. The system installed by Rader was designed and purchased by Martin to handle the chips produced by two chippers, the core chipper supplied by Soderhamn and the veneer chipper which had been in operation for nine years (Tr. 1863). When the Archer proposal was accepted by Martin it had in mind, and did in fact, install a third chipper to handle the "round-up" from the peeler blocks (Tr. 1041, 1100). The installation of a new chipper to make chips out of material that previously had gone into a hog from there to the burner (Tr. 1099-1100) would increase the load on, and requirements for, the chip conveying system. This additional load and requirement was engineered into the Archer system. It can only be speculation what portion of the cost must be allocated to this increased load requirement which did not exist at the time of the Soderhamn contract.

Finding of Fact 16. Brushes, R. 93 (Conclusion of Law 2, R. 94, line 4).

This matter of $941.38 for brushes is silly. The item was not provided for in the contract. This claim belongs in the category of those that were withdrawn, such as the slasher saw.

Finding of Fact 18. Miscellaneous, R. 93 (Conclusion of Law 2, R. 94, line 6).

This finding was all that was finally left of a mass of unrelated odds and ends Martin threw into its contentions. See R. 20. This one should have met the same fate. Soderhamn carried the insurance under this contract until January 19, 1963 (Tr. 1012). The work of installation was completed in September, 1962. The all-risk insurance is a matter Martin has carried since about that time and should have carried from the time McManama completed the project. The barker was in operation and providing substantial profits for Martin. Soderhamn's insurable interest in the machine during this period is as questionable as Martin's attempt to surcharge it with the insurance.

Conclusion of Law 6. R. 95.

The Conclusion of Law necessarily falls if this court sustains this appeal on any one of the foregoing analyses of the findings and conclusions. Moreover, it is erroneous insofar as it includes an allowance of interest. This allowance was carried over to the judgment and is challenged in Specification of Error 4, argued infra, p. 89.

The analysis of any one of the findings by Judge East, taken by itself, should be conclusive that "a

mistake has been committed" (*United States* v. *United States Gypsum Co.*, supra, 15). He simply "failed to make a sound survey of or to accord the proper effect to all the cogent facts" (*Nee* v. *Linwood Securities Co.*, 174 F.2d 434, 435 (8th Cir., 1949). Taken all in all, the result was a judgment based on Conclusions of Law which were in turn based on Findings of Fact which are unsupported in the record and are in many instances purely speculative, particularly as to damages.

SPECIFICATION OF ERROR NO. 4
SUMMARY

The trial court, in entering judgment for the defendant, allowed interest from January 1, 1964 (R. 99). The allowance was erroneous because: 1) controlling Oregon law does not permit interest in the circumstances of this case; 2) there was no demand for interest in defendant's pleadings; and 3) the date of January 1, 1964, has no relationship to any fact or event in this case.

ARGUMENT

Judge East made Conclusion of Law 6 (R. 95) that:

> "Defendant is entitled to judgment against the plaintiff in the sum of $182,112.23, less the unpaid balance on the contract of $61,395.98, or for the net sum of $120,716.25, together with interest thereon from the 1st day of January, 1964, at the rate of 6% per annum, . . ."

This conclusion was in substance made part of the judgment (R. 99):

> "That defendant, . . . , do have judgment for and recover of and from the plaintiff, . . . , the sum of $120,716.25, together with interest thereon from the 1st day of January, 1964, at the rate of 6% per annum, . . ."

Neither in its Answer and Counterclaim (R. 5) nor in its pretrial contentions (R. 13-21) did defendant make a demand for interest. It has long been settled in Oregon that interest on a claim for breach of contract is a matter of damages, for which a demand is necessary. *Ferguson* v. *Reiger*, 43 Or. 505, 512, 73 P 1040 (1903); *Obermeier* v. *Mortgage Company Holland-American*, 123 Or. 469, 481, 259 P. 1064, 260 P. 1099, 262 P. 261 (1927); *Southern Pacific Company* v. *Oregon Growers Co-Operative Association*, 127 Or. 364, 272 P. 281 (1928). Not having been claimed as damages, interest could not properly have been allowed.

Moreover, interest was not allowable, even if demanded. The controlling statute is ORS 82.010(1)(a). Under the statute interest is allowable only on money "due," that is, when there has been a wrongful withholding of money in an amount which is either ascertained or is ascertainable by simple computation or by recognized standards. *Lundgren* v. *Freeman*, 307 F.2d 104, 111 (9th Cir. 1962). Clearly in this case there could have been no wrongful withholding where the amount was in dispute and the defendant himself abandoned some $84,000.00 of his claims after trial. Furthermore, it should go without saying that the amount was not ascertained or ascertainable by simple computation or reference to a standard. See *Lundgren* v. *Freeman*, supra.

Finally, there is nothing in the record of this case,

including the docket entries (R. 109), which can possibly give any significance to the date of January 1, 1964.

The trial court's award of pre-judgment interest was error.

SPECIFICATION OF ERROR 5
SUMMARY

The testimony of Mr. Ray Martin, Martin's general manager (Tr. 845-1255), was directed toward three points in support of defendant's counterclaim: (1) the contents and meaning of the contract; (2) plaintiff's defective or deficient performance; (3) defendant's damages. As to the last, his testimony was based almost entirely on Exhibit 929. The exhibit was not used to refresh recollection; it was claimed to contain the evidence of defendant's damages. The witness admitted that he had no personal knowledge of the facts as to damage other than what was contained in the exhibit. Because the exhibit does not contain the evidence purportedly relied upon, Mr. Martin's testimony had no foundation and ought to have been stricken—or, at least, ignored by the trial judge. The error was prejudicial, because without Mr. Martin's testimony there is no evidence as to many of the elements of damage.

ARGUMENT

Throughout the arguments of Specifications of Error 1, 2 and 3, it was repeatedly pointed out that proof of defendant's alleged damages depended on the testimony of Mr. Ray Martin, defendant's general manager, based on Exhibit 929 (See pp. 21, 30-31, 37,

42, 67-69, 78, supra). The exhibit itself was troublesome. It was offered during the testimony of defendant's Mr. Kemp (Tr. 665), who had identified it as containing "only the work done by Martin Bros. and the materials furnished by Martin Bros." (Tr. 664). Mr. Kemp admitted having no knowledge of the contents other than what he got by examining it at the trial (Tr. 665). He did not put the exhibit together (Tr. 667). Plaintiff's counsel reserved the right to examine the exhibit for relevancy or hearsay (Tr. 668), and it was received subject to that reservation.

Subsequently Mr. Martin was permitted to summarize the contents of the particular folders in the exhibit (over plaintiff's objection that the records would speak for themselves (Tr. 891-892; 1137)), even though Mr. Martin had no knowledge (Tr. 1137-39; 1166) other than what was contained in items in the exhibit (Tr. 894-896; 1204). By the time Mr. Martin had finished testifying even the trial judge recognized that the record was in need of purification (Tr. 1259). The judge also recognized that much of Mr. Martin's testimony (particularly as to costs) was hearsay, but he held it not prejudicial (Tr. 1260). Plaintiff's counsel pointed out that if the exhibit did not contain relevant and admissible evidence of the facts Mr. Martin testified to, then the testimony was without foundation, and it would be prejudicial. This court has pointed out that it cannot be assumed in non-jury cases that the trial judge ignored inadmissible testimony. *Smallfield* v. *Home Insurance Co.*, 244 F.2d 337, 341 (9th Cir. 1957).

Just what Exhibit 929 is supposed to be is very confused in the record. With the exception of groups of orange colored time cards, Mr. Martin admitted that the contents of the exhibit as offered were not

business records of Martin (Tr. 1163-64). The exhibit was prepared specially for the trial (Tr. 1163). There are *copies* of invoices, notes, *copies* of summaries of invoices on Sutherlin letterheads and miscellaneous papers. Many of the invoice copies or summaries contained pencilled notes made by Mr. Kemp for the trial (e.g., see Tr. 1158, 1162-63, 1165). Appendix B to this brief outlines most of the folders in the exhibit. All of the Sutherlin summaries were supposed to have been removed from the exhibit by defendant's counsel (Tr. 1257), but were inadvertently returned (Tr. 1257). The summaries were again ordered removed (Tr. 1257), but they were never removed and are still in the exhibit.

Turning then to the specifics of Mr. Martin's testimony, and taking the items as they came up at the trial, we find the following:

1) $2,963.03 (Finding of Fact 2, R. 87, Ex. 929, folder 2) was for work on the log haul (Tr. 80-89). The folder contains *only* a Sutherlin summary, which is not supposed to be there.

2) $11,609.73, including $28.88 for Martin labor (Finding of Fact 1, R. 86-87, Ex. 929, folder 1) for rewelding and bracing the barker structure (Tr. 892, 895-896). The folder contains only time cards and a Sutherlin summary, which is not supposed to be there.

3) $4,116.00, for steel installed on the transfer deck (Finding of Fact 3-D, R. 88 Ex. 929, folder 3 ABCD) by McManama (Tr. 898-899). The folder contains, *inter alia*, an invoice from McManama & Company for $2,881.20, which bears notes by Kemp and a pencilled figure of $4,116.00, and another McManama invoice (with a different purchase order number) for $1,833.10, also with Kemp notes.

4) $11,429.48 was said to be for steel on the transfer deck (Finding of Fact 3-D), kickers, kicker shafts (Finding of Fact 3, A, B and C) and hog pits (Finding of Fact 3 E, R. 87-88, Ex. 929, folder 3 A-BCD) (Tr. 903). Again the folder contains annotated invoices and Sutherlin summaries. Later the witness segregated, on some unexplained basis, $5,480.38 from the folder as being for Findings of Fact 3A, B and C (Tr. 1027).

5) $2,758.16 for sheer aprons (Finding of Fact 4, R. 88-89, Ex. 929, folder 4) replaced by Sutherlin (Tr. 906). This folder contains *only* two handwritten notes and an adding machine tape.

6) $4,736.96 for additional barker refuse conveyors (Finding of Fact 5, R. 89, Ex. 929, folder 5) claimed under the contract (Tr. 908-911). The folder contains Kemp annotated invoices, some of them representing actual charges by McManama, but the rest are unrelated in their terms to anything.

7) "$4,807.79," said by Mr. Martin (Tr. 913) to be "in the main" for shrouding, was in fact unrelated to any amount in the pretrial contentions in relation to shrouding (R. 15) or Finding of Fact 6-A, R. 89, or any folder in Exhibit 929. Later (Tr. 1028) Mr. Martin extracted $2,195.47 as the amount for shrouding, but gave no explanation.

8) $5,444.34 for additional log lifts supposedly paid to Sutherlin (Finding of Fact 6-B, R. 89). This testimony (Tr. 917-918), too, was unrelated to any specific part of Exhibit 929, except as included in folder "6-D, Part 6A" (Tr. 918), which contains two Sutherlin summaries with Kemp notes, two invoices, some time cards and an adding machine tape. Again the witness later (Tr. 1028) managed somehow to

extract the figure of $9,563.54 for two log lifts. (N.B. The claim for *two* lifts was subsequently abandoned).

9) $2,475.00 for the saw deck roof is again unrelated to any particular folder in Exhibit 929 and bears no relation to anything in Finding of Fact 6-D, R. 90. The testimony was actually referring to a Kemp marked invoice in the folder last referred to, plus time cards (Tr. 921).

10) $2,915.06 for hydraulic system repair (Finding of Fact 7, R. 90, Ex. 929, folder 7) is based on a Sutherlin summary, plus time cards and several invoices which are either indecipherable or are inexplicable without Kemp's notes (Tr. 926-927).

11) $2,666.56 was said to be for "labor . . . and the other items that were necessary in connection with these failures of the debarker" as substantiated by folder 8-A (Tr. 950). (Finding of Fact 8 (a), R. 90-91, Ex. 929, folder 8-A). This folder contains only time cards for approximately 118 hours.

12) $8,496.82 was claimed to be based on "records" in the exhibit detailing expenditures by Martin for tearing down and rebuilding the barker structure for the new Nicholson machine (Finding of Fact 8 (b), R. 91). This item appears to be the total of two folders, both labeled "Part 8 (b)," one called "COST TO REMOVE OLD BARKER" and the other "RECONSTRUCTING BARKER BUILDING." The former has a handwritten note which would indicate Martin paid $500 for removal of the building, and a letter containing third hand hearsay. The latter has time cards, a time summary and odds and ends of invoices, which do not even contain Kemp's notes (Tr. 963-964).

13) $283.00 was said to be Martin's labor cost in

barker start up (Tr. 964). This was said to be based on a folder which must be the one labeled 8 (c). Oddly the folder and the finding (Finding of Fact 8 (c), R. 91) showed different figures from Mr. Martin's testimony.

14) $422.90 was said (Tr. 967) to be the cost of relocating the console (Finding of Fact 9, R. 91, Ex. 929, folder 9). Again, there is a Sutherlin summary, (which, incidentally, has nothing to do with the console relocation), time cards, four identical invoices which bear a figure not apparently related to anything and an adding machine tape. (Martin was not certain about how to interpret the adding machine tapes which he had had made up and which are common to all of the folders of Ex. 929. Tr. 1103, 1110).

15) $14,063.02 was claimed to be the expense of altering the conveyor to the hog (Tr. 971). (Finding of Fact 10, R. 91, Ex. 929, folder 10). With exception of an invoice and a time card, this whole piece of testimony was based on a Sutherlin summary.

16) $12,014.74 was said by Mr. Martin to be shown in Exhibit 929 as the cost of correcting the problems with the horizontal chipper feed system (Finding of Fact 12, R. 92), as well as the now abandoned claim for a slasher saw in the mill (Tr. 979-980). Oddly enough it contains three invoices which are marked by Kemp as applying to the barker. There is one other Kemp marked invoice. But in the main, the exhibit contains time cards (with accompanying calculations) and the ubiquitous Sutherlin summaries. Nothing shows what part of the labor applied to what, although Kemp's notes on the time cards indicate that many of them related to the slasher saw and the "chip loading center," which have nothing to do with this claim.

The foregoing summary touches only on those claims which are still alive and excludes those which Martin has abandoned. The whole point is that Mr. Martin's testimony, insofar as Exhibit 929 is concerned, was based solely and explicitly on the contents of the various folders. In some instances it has been shown that the folders just do not have the data, even if the Sutherlin summaries are recognized. It is clear in the record that those summaries were excluded both by agreement of the parties and by the court's order. But they remain in the exhibit. Nonetheless, they should be excluded as a foundation for Mr. Martin's testimony. Except for the time cards, none of the other items in the folders furnishes any foundation for his testimony. The sum of his testimony was rank hearsay and ought to have been stricken.

To give effect to Mr. Martin's testimony was inherently prejudicial. The only other evidence of damages was by Mr. Halverson of Sutherlin and related *only* to that company's invoices: Exhibits 916, 917, 918, 921-A, 921-B and 931. None of the Sutherlin invoices in those exhibits equal the claimed damages, because in each instance cited above Martin claimed an *additional* amount for labor, materials or the work of others. Moreover, it was shown repeatedly in discussing the evidence adduced in support of defendant's contentions that Mr. Halverson was himself frequently in error as to which Sutherlin invoice applied to which part of defendant's contentions (see, supra, 20). Without Mr. Martin's testimony the proof fails, and with that failure all of the trial court's findings must fall.

CONCLUSION

Each and every one of the trial court's Findings of Fact is clearly erroneous and resulted from the trial judge's failure adequately to review the evidence. Each and every one of the trial court's Conclusions of Law, based as they are on the erroneous findings, must perforce also be held erroneous. A judgment based on those findings and conclusions is necessarily erroneous. The trial court erred in allowing prejudgment interest because it was not demanded, and, moreover, was contrary to controlling Oregon law. Finally, the trial court erred in failing to strike the testimony of Mr. Ray Martin, based on Exhibit 929, because the exhibit was an insufficient foundation for the testimony.

Respectfully submitted,

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Of Counsel for Appellant Soderhamn Machine Manufacturing Company

By GEORGE M. JOSEPH

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

George M. Joseph
Attorney

APPENDIX A

TABLE OF EXHIBITS

Number		Iden.	Offered	Rec'd
127	TWX Kemp to Kornberg, 22 November 1961	176	....	....
128	Letter from Kornberg to Kemp, 24 November 1961	176	....	....
129	TWX Thoming to Kemp, 27 November 1961	176	....	....
130	TWX Hill to Kemp, 28 November 1961	176	....	....
131	Letter from Kemp to Kornberg, 28 November 1961	176	....	....
132	Letter from Rader Pneumatics to Martin Bros, dated October 16, 1961	....	1831	1832
133	Drawing of Conveyor	....	426	426
134	Letter dated 11-12-64	839	839	839
135	Letter from Rader Pneumatics to Martin Brothers, dated January 15, 1962	....	1831	1832
136 through 216	As listed in pretrial order	....	187	187
217	Drawing #218-II-607, Saw Conveyor System Drive	....	159	160
218 through 399-J	As listed in pretrial order	....	187	187
401 through 601	As listed in pretrial order	....	187	187
602	Letter B, Paul Kornberg to Dick Kemp, dated June 18, 1962	....	134 187	135 187
603 through 677	As listed in pretrial order	....	187	187
678	Letter from Dick Kemp to George Thoming, dated September 5, 1962	....	134 187	135 187
679 through 685	As listed in pretrial order	....	187	187
686	Letter from Soderhamn to F. L. Martin, dated September 24, 1962	....	134 187	135 187

Number		*Iden.*	*Offered*	*Rec'd*
687 through 690	As listed in pretrial order	....	187	187
691	Letter from Dick Kemp to Gust Jacobson, dated October 2, 1962	....	134 187	135 187
692 through 900	As listed in pretrial order	....	187	187
901 through 906	Depositions	....	187 1310	187 1310
907	As listed in pretrial order	....	187	187
908	As listed in pretrial order	....	187	187
909	McManama Deposition Exhibit No. 1	59	187	187
910	McManama Deposition Exhibit No. 2	59	187	187
911 through 913	As listed in pretrial order	....	187	187
914	Survey of Condition Existing & Remedial Work performed to place same in operable condition	....	199 351 359	362
915	As listed in pretrial order	....	1299	Withdrawn
916	Copies of invoices to Martin Brothers	....	350	353
917	Invoices on Debarking & Chipper System	....	350	....
918	Invoice for Material to the site to Reinforce Structure on Saw Deck	....	350	....
919	Soderhamn Pamphlet No. 1 Containing Proposal to Martin Brothers	....	131	132
920	As listed in pretrial order	....	187	187

Number		*Iden.*	*Offered*	*Rec'd*
921-A through 921-N	As listed in pretrial order	....	350	356
	pretrial order	....	350	356
922	As listed in pretrial order	....	187	187
923-A through 923-C	Films	....	20	20
		....	187	187
924-B	Business Records	....	497	....
924-C	Business Records	....	497	....
925	As listed in pretrial order	....	187	187
928-B	Summary Sheets	....	665	Rej. 670
929	Box of Business Records of Time Cards and Work Records		665	669
930	As listed in pretrial order	....	187	187
931	Time Cards & Work Order ..	357	187	187
Tozier No. 1—Paper signed by Tozier				208
Tozier No. 2—Drawing				247
Tozier No. 3—Records				325
Harry Czyzewski—Drawing				616
All sketches made by any of the witnesses....				616

APPENDIX B

Exhibit 929

SUMMARY OF CONTENTS

Folder	Subject	Amount	Contents*
1	Welding	$11,609.73	Time Cards and Summaries
2	Log Haul Drive	2,969.03	Summaries
3 ABCD	Deck and Kickers	11,429.48	Time Cards, Invoices and Summaries
4	Sheer Aprons	2,758.16	Yellow notes and tapes
5	Conveyor	4,736.96	Time Cards and Invoices
"Part 6"	Shorten log conveyor	15.40	Time Cards
6 C	Outfeed	56.00	Summary
6 D, Part 6 A	Saw Deck	12,796.61	Invoices and Summaries
Part 6 B	Log Lift	1,070.82	Time Cards, Time Summary and Invoices
7	Hydraulic System	2,915.06	Time Cards, Summary and Invoices
8 A	Barker Repair	2,666.56	Time Cards
Part A(b)	Removal Barker Building		Nicholson Invoice
Part 8 B	Reconstruction Barker Building	6,196.82	Time Card, Time Summary, Invoices
Part 8 B	Removal Barker	23,000.00	Nicholson Note and Letter
8 (c)	Break In	291.83	Time Cards
9	Console	422.90	Time Cards, Summary and Invoices
10	Conveyor to Hog	14,063.02	Time Cards, Summary and Invoice
Part 12 A, all 12 B	Horizontal Chipper Feed	12,014.74	Summary (Chipper) Summary (Ring Repair), Time Cards and Invoices
Part 12 A	Conveyor Chain Hookup	4.15	Time Cards
Part 12 A	Sawmill Chipper	1,050.00	Notes
14	Chipper Belt Roof	558.10	Summary
15	Blower System	12,397.00	Rader Bid
16	Brushes	941.38	Summary
17	Walks and Stairway	2,348.00	Invoice
18 C	Core Chipper	433.13	Time Cards
18 D	Freight	220.85	Invoices
18 A	Crane Rental	10,837.23	Time Cards
18 B	Steel Bolts, etc.	260.03	Time Cards and unidentifiable matter
18 G	Labor	3,457.17	Time Cards
18 F	Labor	8,646.04	Time Cards

* "Time Cards" are orange colored cards which are records of Martin. "Summaries" refer to copies of summaries of invoices on Sutherlin letterheads. "Invoices" are copies of invoices other than from Sutherlin.

22281

United States

COURT OF APPEALS

for the Ninth Circuit

SODERHAMN MACHINE MANUFACTURING COMPANY, a corporation,

Appellant,

v.

THE MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., a corporation,

Appellee.

APPELLEE'S BRIEF

Appeal from the United States District Court for the District of Oregon

HONORABLE WILLIAM G. EAST, Judge

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COURT OF APPEALS

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Appellee.

APPELLEE'S BRIEF

Appeal from the United States District Court for the District of Oregon

Honorable William G. East, Judge

JURISDICTIONAL STATEMENT

Appellee hereby accepts and adopts the jurisdictional statement of Appellant's Opening Brief.

STATEMENT OF THE CASE

For a fuller understanding of this appeal we deem it desirable to supplement Appellant's Statement of

the Case and to present some corrections thereto. For convenience we will refer to Plaintiff-Appellant as Soderhamn, and to Defendant-Appellee as Martin.

In 1961, Martin, operating, at Oakland, Oregon, a plywood plant and sawmill, decided to add to the existing plant a log debarking system, and a chipper system to convert waste wood products into marketable chips. Negotiations for installation of these systems were entered into with equipment manufacturers, including Soderhamn and McManama & Co., of Seattle. In April, 1961, Soderhamn prepared a schematic drawing of a portion of a proposed installation, identified in the list of exhibits as Exhibit 122. In May, McManama & Co. presented to Martin a proposal (Ex. 401) for a Core Chipping System and a Barker System, and for modification of an already existing Veneer Chipping System at the Martin plant. Later McManama & Co. quoted an additional cost for steel piling and steel substructure of $26,732 (Ex. 404). In July Soderhamn submitted a proposal for installation of a complete Log Debarking-Chipping System with all components necessary for a completed plant (Ex. 100). This proposal, together with a supplemental letter wherein Soderhamn designated McManama & Co., its sub-contractor, became the contract for the installation of the systems.

The contract estimated that approximately six months would be required to complete the entire installation (Ex. 100). McManama & Co., the subcontractor for Soderhamn, as work on the installation

progressed, became enmeshed in financial difficulties (Tr. 1486; Ex. 902, p. 5). At one stage of the work Soderhamn was required to assume the McManama payroll (Exs. 529, 530, 532). Martin was given notice of a mechanic's lien for $10,721.64 (Ex. 604) and Soderhamn had to assure Martin (Ex. 609) that Soderhamn would protect the Martin property from any liens arising through McManama's financial difficulties. The Comptroller of Soderhamn expressed his opinion to Martin that McManama & Co. had "hoodwinked" Soderhamn (Ex. 534).

The work was not completed in the expected six months, nor within a year, but dragged along until September 1962, when McManama & Co. left the job, with some of the work not completed and with much of the work poorly and inadequately done.

On October 1st, 1962, Martin by TWX informed Soderhamn (Ex. 689) that Martin was, as of the following day, starting with completion of the installation with outside help, and would charge the expense back to Soderhamn.

A general description of the systems to be installed by Soderhamn may be appropriate at this point.

The Barker system was intended to debark logs, cut them to suitable lengths, and deliver them either to the mill pond, or, for sinker logs, to a point on solid ground near the mill pond. This operation necessarily generated large quantities of debris in the form of splinters, pieces of bark, sawdust, and the like. This

debris was to be gathered constantly from all parts of the Barker system into conveyors and transported into a Hog which chewed the pieces to proper size. The hogged material was then to be delivered, by means of a pneumatic blowing system, to fuel bins adjacent to the steam generating plant on the premises.

The Chipper system was intended (1) to chip up the cores of logs, from which the recoverable veneer had been stripped, into chips, and to transport the chips into a chip bin by means of a pneumatic blowing system, and (2) to pick up slabs and other debris from the sawmill, separate the chippable material from waste material by means of a shaker roll, chip up the chippable material in a horizontal Chipper and deliver the chips to the chip bin.

As Appellant's Brief states (p. 22) Soderhamn is essentially a manufacturer of machines. Among the machines furnished under the contract were the Hog above mentioned, and a Core Chipping Machine, of Soderhamn manufacture, which were well made. The story which respect to the De-barking Machine which Soderhamn attempted to supply is entirely different.

By the contract (Ex. 100, p. 9) Soderhamn agreed to furnish a 60″ Soderhamn Debarker, with electric starters and controls and console, approximate shipping date five months from receipt of order, for which there was a specified price of $81,500.00.

The Debarker was not manufactured at any plant of Soderhamn, but a Portland machinery company was engaged to build it (Tr. 77). No Debarker of the

type and size was in existence and none had ever been built before by Soderhamn (Tr. 77). The rotor was to be operated by means of a ball-bearing device, for which the balls and races were to be supplied by a German concern (Tr. 76). Manufacturing difficulties and delays were encountered (Exs. 437, 455).

Difficulties in attempted operation were even worse. We have summarized some of these difficulties in the attached appendix.

We will discuss the contentions of the parties and the findings of the Court as regards the Barker, as well as the objections of Appellant to other findings of the Court, in connection with Appellant's specifications of error.

As Appellant states (Br. p. 7-10) Martin claimed in the pre-trial order that Soderhamn had failed in the performance of its contract with Martin in some nineteen particulars. During the course of the trial and in examination of the multitudinous exhibits received it was made to appear that the claim of Martin in some respects could not properly be sustained.

Examples of these contentions are that a fair construction of the contract will not justify a requirement that Soderhamn supply a slasher saw. For another instance, a claim for loss of chip revenue could not be sustained for the reason that the core chipper was operating and producing chips even though the Debarker was inoperable. Also in the assembly and sorting of the large number of invoices and other documentary material relating to costs there occurred some duplication of charges.

In carefully prepared briefs after an exhaustive study of the transcript of testimony and of the many exhibits, any pre-trial contention claim not fully proved to be meritorious and all duplications of charges were eliminated. As Appellant puts it in the brief (p. 12) "Defendant thus abandoned claims totalling about $84,000."

The Findings of Fact, as finally entered by the Court, eliminated all portions of the Martin contentions of the pre-trial order so "abandoned," and embraced only credits and counter-charges of Martin fully proved at the trial, and only in amounts fully sustained by the evidence. The details will be covered in discussion of Appellant's Specifications of Error to which we now turn.

ARGUMENT ON SPECIFICATIONS OF ERROR 1, 2 and 3

In this action jurisdiction is based on diversity of citizenship, and we assume that the Oregon law is pertinent, if not controlling, on the question of how far an appellate court may go in upsetting the findings of a trial court in a case tried to the court without a jury.

In a case tried to the court without a jury, it is not the function of the appellate court to review the evidence, and the finding of the trial court is final if there is any evidence in the record to sustain the finding. *Brownsville Particle Board* v. *Overhead Door Co.*, 244 Or. 424, 417 P.2d 1019 (1966).

Where a question of fact is to be determined and

the court has found the fact in favor of a party, the appellate court has no power to disturb the finding. *Hunt* v. *Ferguson-Paulus Enterprises*, 243 Or. 546, 415 P.2d 13 (1966).

In a law action tried by the court without a jury the findings of the court have the force and effect of a jury verdict and must be affirmed on appeal if supported by any substantial evidence. *Kuzmanich* v. *United Fire and Casualty Co.*, 242 Or. 529, 410 P.2d 812 (1966).

The findings of the trial court may not be set aside upon a "weighing" of the evidence. *Gordon Creek Tree Farms* v. *Layne*, 230 Or. 204, 358 P.2d 1062, 368 P.2d 737 (1962).

The rule is the same under Rule 52(a) of the Federal Rules of Civil Procedure. In *Cataphote Corporation* v. *De Soto Chemical Coatings*, 356 F.2d 24 (1966) this Court said:

> "It is not our function to reevaluate the evidence presented below. We can not substitute our judgment for the first-hand evaluation made by the trier of fact. Pursuant to Rule 52(a) of the Federal Rules of Civil Procedure our obligation is to determinine if the findings below were 'clearly erroneous.' This statutorily imposed standard does not vest us with power to reweigh the evidence presented at trial in an attempt to assess which items should and which should not have been accorded credibility. Our task, rather, is to determine if there exists evidence of substance to support the findings of the trial court."

With these rules in mind we will now consider the findings of the trial Judge to see if they are supported in each instance by any substantial evidence.

Barker Foundation Structure

The erection of the barker foundation structure, originally scheduled as a first item of construction, was postponed for other work under the contract. This is important only insofar as the financial condition of the subcontractor worsened as the work progressed, and likewise the quality and integrity of the work.

The subcontractor abandoned the work on September 21, 1962. The barker foundation structure had then been subjected to the stress of intermittent operation of the log haul and barker since the last day or two of June. On October 1st Martin sent to Soderhamn a teletype stating ". . . Martin Bros. are as of Oct. 2nd starting completion with outside help. Same expense to be charged your account" (Ex. 688).

Sutherlin Machine Works, Inc. was called in and did the remedial work necessary to put the structure in shape to sustain the operation. The condition of the structure prior to completion of the remedial work was fully described by a number of witnesses.

Witness Halverson, of Sutherlin Machine Works, said that what caught his eye was the excessive movement of the structure while the unit was in operation, and, that while he was watching, an electrical

relay was knocked out (Tr. 336-7). To him it was quite apparent that there was misalignment of bearing setups, and the primary consideration was to eliminate "excessive sway during the debarking operation" (Tr. 405).

Witness Jones told that when larger logs were being pulled up the log haul, "it would shake tremendously and in short jerks . . . until you would wonder if the thing was going to stay in place" (Tr. 452).

Witness Kemp found excessive vibration from the log haul structure transmitted to the barker structure and over into the saw deck, which later was eliminated by the bracing, gusseting, and welding done by Sutherlin (Tr. 649), before which remedial work "if a heavy log would be kicked out, there would be such a vibration over the saw deck that it would kick out the relays for the saws, for the hog" (Tr. 650).

Witness McManama, "observed movement, I observed a sway of the entire structure, and I certainly observed vibration when a log would go across from the flue (sic) to the feed rolls" (Tr. 1383).

Witness Tozier, working for Sutherlin in the remedial work, was asked in cross examination for an explanation of the lack of welding, and explained, "they just didn't get back to it and weld it after it was built" (Tr. 278).

The summary (Ex. 921) of Sutherlin Machine Works shows that they found in the Log Haul, Barker, Transfers and Saw Deck Structures:

Total ft. broken weld	432
Total ft. ⅜ single pass weld	1966
Total ft. tack weld	851
Total ft. no weld	1055

To complete the structure 3,496 feet of ½ x ½ rewelding and 868 feet of ⅜ x ⅜ rewelding was done. Gussets and braces were added. On the Log Haul portion there was found 109 feet of "no weld" and 80 feet of broken weld. Gussets and braces were added, and 552 feet of reweld was done (Ex. 921).

The necessity for this work is beyond question. The finding as to this item is fully supported by evidence.

This is in effect conceded by Appellant (Brief p. 30) by the charge that Martin made no effort to mitigate its damages. This duty to mitigate was never made any issue in the pre-trial order, however, as the Appellant chose instead to contend that Appellant had fully performed (R. 11).

There was, it is true, some confusion as among the various exhibits, due to the fact that so many witnesses and attorneys handled them at the time of trial. There was, however, no confusion as to the charges assigned to the different pieces of remedial work, as made by the trial Judge in the findings.

For the barker structure the cost of the work by Sutherlin, for labor and materials, was $11,580.85 (Sutherlin invoices D 1626, 1375, 1428, 1410, 1144, 1271, 1271-A, 1141, 1141-A, 1141-C, 1302, 1302-A,

1302-B and 1622) and, as shown by Martin time cards, Martin supplied labor of $28.88, making a total cost of $11,609.73. The testimony of Mr. Kemp and Mr. Halverson, both experienced in such matters, was that this was a reasonable figure.

The finding of the trial Judge as to this item was sustained in all respects by substantial evidence.

Log Haul

As installed by Soderhamn the Log Haul, intended to convey logs from the mill pond up onto the infeed conveyor on the barker structure, was practically inoperable.

The down time summary (Ex. 924-B) shows:

6-28-62	Chain hung up—7 hours down
6-29-62	Log Haul being repaired all day
7-13-62	Log Haul Chain jumped off return rails two times
7-14-62	Log Haul Chain off return three times
7-16-62	Log Haul Chain off drive
8- 3-62	Log Haul fell off return and tore it apart
8- 6-62	Crooked log hung up in log conveyor twice
8- 8-62	Big log stuck in saw trough—knotty log had to be bucked on log haul
9- 4-62	Log Haul hung up and broke
9- 8-62	Log Haul chain came off sprockets
9-14-62	Log Haul chain off drive and return
9-17-62	Log Haul chain off drive sprocket and return

9-21-62	Log Haul off twice
9-25-62	Log Haul off return
9-27-62	Log Haul off return
10- 4-62	Log Haul off
10- 5-62	Log Haul jumped off and hung up—two links broken and had to be welded
10- 8-62	Log Haul off
10- 9-62	Log Haul chain jumped off return seven times

Soderhamn admits the making of some changes in the system to make it operable (Br. 34) and that Sutherlin, after McManama left the job, "made a change in the drive system to an S-drive" and did some other work (Br. 34). The work done to make the Log Haul operable, consisting of the addition of a suitable tension system, or "S" drive, the installation of heavy return rails and incidental work, was fully described by the witnesses Halvorsen and Kemp, and these witnesses also testified as to the reasonableness of the charges. The cost of this work was $2,963.25 (Sutherlin invoices D 1201, 1201-A, 1201-B, 1201-C) plus $5.78 in Martin labor. The trial judge found on substantial evidence that the reasonable and necessary cost, in labor and material, to make the Log Haul conform to the contract was $2,969.03.

Kickers and Kicker Shafts

The system to be installed by Soderhamn included a conveyor to take the debarked logs to a series of saws. The logs, after being cut into suitable lengths,

were then "kicked" into the log pond or, for sinker logs, in the opposite direction to a sinker deck. This kicking was to be done by a series of steel arms activated by the turning of a shaft held on the barker structure by bearings.

Although the contract contemplated completion of the entire system in six months, or thereabouts, it was not until about the first of the following July after the signing of the contract that this portion of the system was ready for operation (Ex. 924B). Then in a few weeks time the kicker shaft, because of insufficiency of size, quality of steel and number of supporting bearings, became practically inoperable, and the kicker arms bent out of shape and became useless (Tr. 211).

Mr. McManama attempted to excuse this sort of kicker arms by explaining that breakable arms were desirable to train an inexperienced operating crew (Tr. 1396).

Soderhamn was advised that the shaft that activated the kickers had to be changed (Ex. 718).

To make the kicker system operable the shaft was replaced with a shaft of larger size and better quality steel. The structure was reinforced, and additional bearings for the shaft installed. New kickers of better steel, capable of doing the work, were installed. Sutherlin invoices 1559, 1615, 1368, 1368-A, 1306, 1306-A, 1365 and 1241, totalling $5,392.25, and Martin time cards for $53.13 labor and Northwest Machinery Sales invoice for $35 cover the cost of the work.

Again the finding is supported by substantial and convincing evidence.

Steel Decks, Walkways and Stairways

As Appellant states (Br. 38) with reference to the decks, stairs and walkways of the barker structure, "The matter of the materials to be used for walkways and deckings simply is not mentioned" in the contract. Neither, for that matter, are walkways and stairways themselves in the contract between Soderhamn and its sub-contractor, McManama & Co. (Ex. 522). But no dispute ever arose over the necessity for decks, stairs and walkways in a completed and functional structure. The Court found that they should have been constructed of steel instead of wood. Initially a structure of treated piling and timber caps was proposed (Ex. 401, p. 2). By phone a quote for the additional cost of a steel structure was asked for, and McManama & Co. quoted an additional cost of $26,732 for steel substructure, including (not consisting of) steel piling, x-bracing and caps (Ex. 404). The only mention of wood in the contract is in connection with the frame of the galvanized sheet metal building on the barker structure and the frame of the galvanized sheet metal building on the chipper assembly. The wood frames were eliminated by appropriate change orders (Exs. 111 and 117) and the additional cost was paid by Martin, and there is no dispute about this. A steel structure was the subject of the correspondence, with its additional cost, before the contract was signed. No material was specified

for the walkways, stairs and deck. The trial Judge was justified in finding that steel was contemplated and should have been supplied.

If ambiguous with regard to the material for decks and walkways, the contract should be construed, under familiar rules of construction, against Soderhamn, the party preparing it. *Quillin* v. *Peloquin*, 237 Or. 343, 391 P.2d 603; *Cimarron Ins. Co.* v. *Travelers Ins. Co.*, 224 Or. 57, 355 P.2d 742.

Pits Under Hog, Surge Bin and Feeder

As to the necessity for this part of the installation there is no dispute whatever. Appellant's brief (pp. 44-5) concedes the need for these pits.

The contract clearly called for a bark conveyor to carry the bark and other debris from the barker to a surge bin at the edge of the pond; for a surge bin to receive this bark and debris and meter it to the adjacent hog; and for a system to meter the hogged material to a pneumatic system for transport to fuel system (Ex. 100, p. 27).

At the elevation at the edge of the pond at which McManama & Co. by its own choice established this installation, it was necessary to encase the area in what is described as pits under the hog, in order to provide space for the removal of debris and for the maintenance of the conveying equipment (Tr. 659, 1291, 1494).

Soderhamn refused to make this installation as

a part of the system called for by the contract, and Martin was required to put in the pits, at a reasonable cost of $1,833.10.

The finding of Judge East as to this item is amply supported by substantial evidence.

Sheer Aprons or Plating

Soderhamn seeks to avoid responsibility for the reasonable cost of putting steel plating to cover the area over which logs travel from the outfeed conveyor to the left and into the pond, on the ground that the original contract called for only knees to be installed in that area. We respectfully submit that the contract does not so provide.

The contract does provide for the installation of a complete and operable log debarking system. The schematic drawing (Ex. 122) which was prepared to show the general layout proposed by Soderhamn was not incorporated into the contract. Nor was it ever intended to place a limit upon the work and material necessary for a "complete log debarking-chipping installation," or "a completed plant," or a "complete installation" (Ex. 100, p. 1).

Mr. McManama admitted (Tr. 1459-1462) that without the protection of steel plating over this area logs of tremendous weight could fall into and damage the hydraulic piping and valves and electrical conduits underneath the area.

Of the necessity of this work there is no question.

No evidence was offered that the charges for the work, represented by Sutherlin invoices D 1144-A-1 and 1144-B-2, totalling $2,758.16, was unreasonable. The finding of the trial Judge as to this item was supported by substantial evidence.

Bark Refuse Conveyors

Devices were of course necessary to pick up the bark removed from the logs, the sawdust originating with the sawing of the logs, and the other debris generated in the barking-sawing operation. The devices, as installed by Soderhamn, failed to pick up this debris and convey it to the hog. Bark piled up and interfered with proper functioning of the log haul (Tr. 1381, 1599; App. Br. 34). Mr. Kornberg, West Coast Manager of Soderhamn, found an accumulation of waste under the head shaft of the conveyor to the "haul" [sic—Hog] (Tr. 107).

The gathering up, hogging and conveying to burner of essentially all the waste material originating at the barker structure was obviously a necessity in any complete system. To complete the system, so far as pick up and disposal of bark and sawdust waste was involved, Martin was compelled to and did extend the conveying system, at a cost (never contended in any respect to be unreasonable) of $4,736.96. The finding of the Court was fully sustained by the evidence.

Shrouding

To guide the waste material into the conveyors at the barker structure shrouding was necessary. This meant the use of plate or sheet steel sheers to provide protection against spillage (Tr. 144). Soderhamn had not provided sufficient shrouding (Tr. 214) and Sutherlin completed the shrouding installation at a reasonable expense of $1,917.06. The pre-trial contention figure was $2,975.47, (R. 15), but the trial Court eliminated the item of replacing sawdeck plates of which Appellant is now complaining (Br. 51). The figure found by the Court was proper and reasonable and should not be disturbed on this appeal.

Saw Deck—Log Lifts—Modification of Structure—Sinker Deck Drive—Roof Over Saws

Contention 6 of Martin in the pre-trial order (R. 15-16) had to do generally with that portion of the structure supporting the log sawing operation; the lifting and sawing of logs; and their transfer to sinker deck. It was found necessary in order to make an operable system to strengthen and modify the structure; to put guides to keep the lifting pins, used to lift the logs to be sawed, in place; to install an additional pair of lifts; to rearrange the drive for the sinker log operation; and to provide a lean-to type of roof over the saws and their operators. Also, discussed above, there was involved the placing of shrouding in such locations as to channel the sawdust into the conveyors to the hog.

As to the log lifts portion of this contention, no dispute exists but that the contract provided for a complete set of lifts for each saw, each to be operated by heavy duty hydraulic cylinders with all controls (Ex. 100, p. 11; App. Br. 53). Soderhamn contends (Br. 53) that a complete set of lifts for each of four saws means four pairs of pins. From abundant evidence the Court found otherwise. A log lifted up in the air to be sawed, if sawed with one saw, needs a lift at each end; if sawed with two saws, needs three lifts; and so forth. The evidence left no doubt but that an additional pair of lift pins was required, and that the lift pins needed guides which Soderhamn failed to supply (Tr. 217, 915).

As concerns the sinker deck modification, a $56.00 item, the evidence supporting the necessity for this is clear. Logs which would sink if kicked into the pond were to be transferred to a point where they could be picked up by a lift truck and transported to the lathes. The transfer chains are activated by a drive sprocket. This sprocket was so placed that the forks of the lift truck were likely to hit it (Tr. 918-9). The sprocket was relocated so as, in the words of Appellant's Brief (p. 54), "not to have this drive unit exposed as much as it was previously."

A lean-to type of building over the saws, to protect the operators as well as the saw mechanism, was an obvious necessity as part of a complete system. Soderhamn had planned to put in a small lean-to type of cover (Tr. 113). The literature submitted in con-

nection with the installation showed a roof over the saws (Ex. 919). The Court found that the contract provided for a roof over the saws. A construction cost of $1,161.00 for the roof was quoted by McManama (Ex. 561). Martin determined that a 4 foot extension was desirable and that the additional cost would be assumed by Martin. The total cost of the roof, with the extension, was $2,543.59, which is the amount contended for in the pre-trial order (R. 16) and which McManama testified was reasonable cost. Since it appeared at the trial that Martin had assumed the additional cost of the extended structure, the trial Court in the findings limited the recovery for this unsupplied item of the contract to the earlier quoted figure of McManama of $1,161.00.

Sufficient and convincing evidence was before the court in connection with this contention 6, and no reason has been shown for disturbing the findings of the Court.

Hydraulic System

That the hydraulic system, as installed by Soderhamn, required corrective work, because of breakage due to lack of flexible connections, has not been questioned (Kornberg Tr. 114, 115; McManama Tr. 1389, 1391). There is substantial evidence that the necessary corrective work had to be completed after the subcontractor left the job (Tr. 369). Due to the defective condition of the system and the breaking of the pipes some hydraulic oil was lost, and had to be replaced by more oil, after Sutherlin Machine had made

the system operable. In the pre-trial contentions the cost of this replacement oil was included; in the findings of the trial Court its cost was eliminated.

In its brief Soderhamn complains that Martin repaired the "subsequent difficulties without giving notice to the contractor of intention to do so" (Br. 57). This overlooks, however, the teletype of October 1st, Exhibit 688, and also the subsequent dozens of communications in the record.

The finding of the trial Court as to the hydraulic system is fully supported in the record.

The Debarker

The difficulties with the debarking machine we have set forth in some detail in the attached appendix. Appellant concedes that the debarker without doubt "gave trouble" (Br. 58).

The correctness of the finding of the trial Court, that Martin was entitled to return of the money paid for the machine, is said by Appellant to be, however, "dependent upon Martin's showing that the seventh bearing failed" (Br. 65). There had occurred six previous bearing failures, admitted by Appellant. The proof of a seventh failure was practically conclusive. The growling of the machine; the metal shavings in the lube pump (Ex. 924-B); the repetition of all the symptoms of the previous failures; and the condition of the races as found and photographed by the Metallurgist, Czyzewski (Ex. 922) all prove overwhelmingly the occurrence of a bearing failure for the sev-

enth time. So, assuming that on this narrow ground, only, the return of the money paid for the machine would be proper, the proof fully sustained the finding.

But the Appellant argues (Br. 67) that if the debarker was defective, as it admittedly was, Martin's damages should not exceed the cost of the machine less a reasonable allowance for the value of the use made of the machine. The difficulty with this position is that Appellant made no contention and offered no proof as to any such reasonable allowance, but contended on the other hand that the parties agreed for their mutual benefit for the return of the barker for resale with credit to Martin only for the net on such resale (Contention 3, pre-trial order—R. 11). As to this contention no proof of such agreement was offered and the Court had no basis for any finding respecting such agreement.

The machine presented endless difficulties. It was finally taken away from the Martin plant by Soderhamn, and no substitute machine was offered to take its place. The trial Court was clearly right in finding that Martin was entitled to recover from Soderhamn the price paid for the machine.

There was some evidence by Martin, denied by Soderhamn, that Soderhamn promised to replace the barker with a Nicholson barker if the one installed did not perform satisfactorily. This promise, however, was not placed in the contract as signed. It therefore appears that the parties entered into a contract, one item of which was that Soderhamn would supply to

Martin a 60″ Soderhamn Debarker, for which Martin was to pay $81,500.00; that Soderhamn made only a temporary delivery of an admittedly deficient article, and removed the same from the Martin plant at Oakland and disposed of the same to others; that so far as this item is concerned, Soderhamn failed completely to perform; and that Martin is entitled to credit against the total contract price for the specified price of this item.

Barker Removal—Barker Building—Labor Furnished By Defendant

The principal objections offered by Appellant to the findings of the trial Court on these three items seems to be that the Court, having refused to strike the testimony of Raymond Martin from the record, considered his testimony of reasonable value as credible. There is no doubt—indeed much of it is in the agreed facts in the pre-trial order — but that the barker caused difficulties in start up, in being taken apart for repair, in being lifted out to be taken to Portland to be re-machined, and in being removed from the barker structure to be taken from the Oakland plant for reconstruction and resale. Some of the details as to the costs incurred were the subject of testimony by Mr. Martin. The details, with supporting invoices, are given in the appendix. As to Raymond Martin's testimony concerning the Martin labor charges, Appellant admits his competency (Br. 97). The reasonableness of the other charges was the subject of testimony by Mr. Halverson, Mr. Kemp and others. Soderhamn chose not to submit any evidence

as to reasonable value to contradict or lessen the value of the Martin evidence on these items. There plainly is no merit to the specification of error as pertains these three items.

Console

This item, amounting to $422.90 reasonable expense in placing the operator's console in a relatively safe place, hardly merits the Court's attention. Appellant says "No one disagrees the console had to be moved" (Br. 72). Appellant claims that the dangerous place where it was installed originally was at Martin's demand, but Exhibit 637, a letter of Soderhamn's Mr. Kornberg, dated August 2, 1962, says that "it was our Mr. Hill who recommended that the panel be mounted in its present position." The trial Court made no mistake in the finding respecting relocation of the console.

Conveyors to Hog

That the conveyor to carry the bark and sawdust to the hog, as installed by Soderhamn, was not capable of sustained successful operation, was amply demonstrated by the testimony of a number of witnesses: Halverson, Tr. 372-3, 417; Jones, Tr. 453; McManama, Tr. 1399, 1402. The "problems Martin had with this conveyor" (App. Br. 73) are in effect admitted by Soderhamn, but are blamed upon the fact that a shortening of the distance from the barker structure to the hog from 80 feet to 67 feet (Br. 73-4), allegedly occurred. Assuming, however, that the hog was

located some 13 feet closer to the barker structure than had been expected, there is no provision in the contract penalizing Martin for so locating the hog; and there is no showing that Soderhamn's subcontractor suggested to Martin that the work of installing a conveyor of shorter length or different grade affected in any way the difficulty or the cost of the installation. No request for any change order appeared. No objection by Soderhamn or McManama to the place where the hog was installed appears in the record.

Much complaint is made of the reasonable cost of the remedial work done. Appellant produced two expert witnesses, Kintz and Wahl, to testify that the cost was unreasonable. Neither of them had spent more than a few minutes at the Martin plant at Oakland. Three witnesses for Martin (Halverson, Raymond Martin, Kemp) gave opinion evidence that the actual cost of $14,063.02 was reasonable. They were all three on the job, so to speak, and had more familiarity with the difficulties than the witnesses for Soderhamn.

The trial Court found that the remedial work was necessary and that the reasonable cost was the amount testified to by these three witnesses. There is no basis for disturbing this finding.

Horizontal Chipper Feed System

This system was intended to separate chippable material from the sawmill refuse enroute to the burner, convey the chippable material to and into a horizontal

chipper, and drop the remaining refuse into the conveyor to the burner. The separation was to be made by what is described as a shaker roll.

As installed by Soderhamn the system failed to get the refuse to the shaker roll (Tr. 125; see also description page 81 Appellant's brief). Then the shaker roll did not make the necessary separation, but a great deal of chippable material went to the burner (Tr. 219, 305, 377). Then the chippable material was not conveyed to the chipper because of "misalignment of the system" (Tr. 377) which was installed in a zig-zag fashion, the longer pieces of wood being unable to travel around the bends and angles. This in turn required constant employee assistance to keep the material moving. The required remedial work was described by Mr. Halverson:

> "We rebuilt the shaker roll so it would pass chippable material on to the chipper. We also put in a belt conveyor ahead of the shaker roll to permit chippable material to be fed from that conveyor to the shaker roll without dropping through. We realigned the conveyor that fed the chipper and repositioned the chipper so it was in more true alignment with the conveyor." (Tr. 377).

This work was found necessary by the trial court, and the cost of the modification was found reasonable.

Appellant complains that Mr. Halverson, in testifying as to reasonable value included in his estimate the amounts contained in Sutherlin invoices D 1785,

D 1871-A and D 2135, which covered other work. These invoices came to the sum of $756.17. This sum was deducted by the trial court from the amount claimed in the pre-trial order contention relating to this item, giving a net reasonable cost for the remedial work of $9,531.57. No basis exists to disturb the findings of the trial Court.

Roof Over Belt

One of the items of the Sawmill Chipper and Chip Loading System to be installed was "A chip conveyor to receive chips from the above cyclone and transport them approximately 80′ to the adjacent 30-unit surge bin. This conveyor to consist of an 18″ belt . . ." (Ex. 100, p. 29).

This conveyor was installed in such manner that the chips had to ride up in a steep incline on the belt to the top of the surge bin. The incline was so steep that when in rainy weather the belt became wet and slick, the chips would not adhere and be transported to the surge bin. To cure this insufficiency the belt was put under cover at a cost of $558.10. The contract clearly called for a system that would transport the chips to the bin, and to make a system that would transport chips as they developed, rain or shine, the roof was necessary, and the cost was reasonable, as the trial Court found.

Chip Blower System

As Appellant states (Brief p. 83) there were three separate pneumatic blower systems installed under

the contract, and two operated satisfactorily. Appellant further states (Brief p. 84) that the contract unmistakably called for the installation of a pneumatic system which would so operate as to convey the chips originating at the core chipper and the chips originating at the veneer chipper to the chip control center. This (third) system admittedly did not operate satisfactorily, but was constantly plagued with what Appellant describes as a "plugging problem" (Br. p. 84). Many suggestions were made as to means for curing the plugging problem, including the suggestion that Martin put the cores into the system as they developed (Appellant's brief p. 85), but the system would not and did not work until redone by Martin after the subcontractor, McManama & Co., walked off the job. The trial Court found on satisfactory evidence that the remedial work was necessary and the cost reasonable.

Brushes to Clean Belts and/or Chains

It was an obvious necessity, in a complete installation, to have the belts and chains, which convey chips, bark and sawdust, operate without having the material adhere to the belt or chain and ride around and around the circuit. McManama & Co. left the job site with many unfinished items, including the placing of brushes where needed to clean the belts and chains and thus prevent this condition. Mr. Kornberg, of Soderhamn, observed "that a certain amount of spillage was occurring because of the lack of brushes" (Tr. 128-9). The number, location and ne-

cessity for the brushes was described in detail by Kemp (Tr. 737). The Court found that they were a necessary item in an operable system, and that the cost of installing them, in the sum of $941.38, was reasonable.

Miscellaneous Charges—Insurance

The contract plainly provides (Ex. 100, p. 3) that the Contractor's (Soderhamn's) standard all risk insurance policy covering the installation is included in the contract price. The supplemental letter states that this part of the obligation of Soderhamn will be performed by McManama, who will furnish an all risk insurance policy which will be included in the contract price. The contract, page 3, provides that this insurance coverage will be continued until completion of the individual systems and required adjustments are made.

The proof showed without contradiction that before the completion of the installation the all risk insurance was cancelled (Ex. 738; Tr. 1012) and that Martin secured insurance protection, first by obtaining a floater at a cost of $410.00, and then, for the succeeding period until November 20, 1963, by securing an indorsement to its insurance policies, covering barker, motor and gear set on barker (Tr. 1265), at a cost of $1,302.81. Since all risk insurance under a policy to be supplied by Soderhamn was included in the contract price, and since it was not furnished by Soderhamn for a portion of the period but was furnished by Martin, the cost of the insurance

is a proper countercharge in the sum of $1,712.81. Mr. Ahl, Insurance Underwriter, gave the details of the coverage and of the cost (Tr. 1262-1268). No proof was presented that either the coverage or the premium cost was excessive or unreasonable.

There is no substance to the Specifications of Error 1, 2 and 3 of the Appellant. It is admitted that there was evidence to support the findings of fact (Br. 15). All that Appellant asks is that this Court reevaluate the evidence. The authorities both of the Oregon Supreme Court and of this Court which we have mentioned above make clear that this Court should not do so.

SPECIFICATION OF ERROR NO. 4

The Appellant, Soderhamn, contending that controlling Oregon law does not permit interest in the circumstances of this case, specifies as error on the part of the trial Court the inclusion in the judgment of interest from January 1, 1964, on the amounts found due to Appellee.

This Court, in the case of *Lundgren* v. *Freeman*, 307 F.2d 104 (1962), has well stated the Oregon law relating to pre-judgment interest, in cases of breach of contract, as follows:

> "Under ORS § 82.010(1)(a), money is 'due' when there is a wrongful withholding of money, the amount being either ascertained or ascertainable by simple computation or reference to recognized standards (E.g., Public Market Co. of

> Portland v. City of Portland, 1943, 171 Or. 522, 130 P.2d 624, 138 P.2d 916; Northern Pacific R. Co. v. Twohey Bros. Co., 9 Cir., 1938, 95 F.2d 220; Northern Pacific Construction Co. v. Wallowa County, 1926, 119 Or. 565, 249 P. 1100). The theory is that the party in breach should compensate the injured party for wrongfully withholding from him the use of an easily ascertainable sum of money after the due date. (Public Market Co. of Portland, supra, 1943, 171 Or. 522, 130 P.2d 624, 138 P.2d 916, 918-919; Northern Pacific R. Co. v. Twohey Bros. Co., 9 Cir., 1938, 95 F.2d 220, 226)."

The leading case of *Public Market Co.* v. *Portland,* 171 Or. 522, 130 P.2d 624, 138 P.2d 916, involved a breach of contract by the City of Portland. The Court determined that there had been a breach, that plaintiff was entitled to recover damages for such breach and that plaintiff "therefore, is entitled to recover the difference, if any, between the contract price and the reasonable market value of the land, building and equipment at the time of the breach" (171 Or. at 591). Upon a rehearing, the allowance of pre-judgment interest having been challenged, the City having contended that since the damages were unliquidated they were not moneys due within the meaning of the statute, the Court (171 Or. 623) held that its previous case of *Northern Pacific Construction Co.* v. *Wallowa County,* 119 Or. 565, 249 P. 1100, governed, and was "unquestionably authority for the allowance of interest on unliquidated damages growing out of the breach of a contract."

The Court further said that *Northern Pacific R. Co.* v. *Twohey Bros. Co.*, 95 F.2d 220, wherein it was held that on breach of contract "any lack of liquidation of damages" would not defeat the right to interest, had been correctly decided.

The rule of these decisions has recently been applied in an admiralty case by the District Court of the United States for the District of Oregon. In *Cia. Estrella Blanca* v. *S. S. Nictric*, 247 F. Supp. 161 (1965), Judge Kilkenny held:

> "Recognizing that Public Market Co. of Portland v. City of Portland, 171 Or. 522, 625, 130 P.2d 624, 138 P.2d 916 (1943), was not a proceeding in admiralty, I am of the belief that the thorough analysis of the subject of interest and the principles there stated, though not controlling, are highly persuasive. The rule stated is equitable, whether employed in admiralty or at common law."

In *United States* v. *Hanna Nickel Smelting Company*, 253 F. Supp. 784 (1966), Judge Solomon made a determination of the amounts payable on overpayments in unliquidated amounts and allowed interest from dates of overpayment, stating:

> "This is a classic case of unjust enrichment. From the dates of overpayments, the Company has had the use of the Government's money. The amounts of the overpayments, as well as the dates, have always been subject to ready calculation, once the existence of a breach was determined" (253 F. Supp. 796).

In the present case Judge East determined that the amounts involved were ascertainable by computation and reference to recognized standards, and that therefore interest was properly allowable from due date rather than date of entry of judgment.

Indeed for a large portion of the amounts involved no ascertainment was necessary. The contract price paid for the barker not furnished constituted an overpayment of $81,500.00; the overpayment of $800.00 on the horizontal chipper was admitted (R. 74); and the reasonable cost of painting blow-pipe in the amount of $218.40 was admitted (R. 73). So under any theory interest on these amounts from January 1, 1964, was unquestionably proper.

The Appellant next argues that, since there was no demand for interest in defendant's complaint, no interest is recoverable. The three Oregon cases mentioned do hold that where there is no demand for interest in the complaint none should be allowed.

But these cases were decided under the Oregon code pleading law, with the statutory requirement (ORS 16.210) that the complaint, if the recovery of money is demanded, must state the amount thereof.

This case was not initiated in the state court where code pleading and practice govern. It was initiated by Appellant, Soderhamn, in the federal court, and was conducted under the Federal Rules of Civil Procedure. The pre-trial order expressly provides (R. 23) that "the pleadings pass out of the case and are superseded by this order." The pre-trial

order sets forth the issues of fact and of law (R. 22) and the non-allowance of interest prior to judgment was not made an issue. In the Appellant's objections (R. 55-74) to the findings prepared by Appellee in response to the decision of the Court, Appellant claimed interest from November 13, 1963, and made no claim that interest was not allowable to Appellee.

Finally Appellant complains that the starting date of January 1, 1964, for the running of interest, has no relationship to any event in the case. It will be recalled that on November 13, 1963, Soderhamn took the barker away from the Martin plant at Oakland. This, perhaps, was the last date to have a "relationship" to an event in this case. Interest from this date was asked by Soderhamn. Interest should have commenced on this date, and delaying the commencement of the running of interest to the first day of the following year, perhaps out of an abundance of caution rather than for any sound reason, does not operate to the prejudice but rather redounds to the benefit of Appellant, and is no ground for complaint.

We think that the findings of the trier of the fact as to the interest should not be disturbed for any of the reasons assigned by the Appellant.

SPECIFICATION OF ERROR NO. 5

During the trial Appellant moved that the Court strike ALL of the testimony of the witness, Raymond Martin, which pertained to the amount expended by Appellee "for these various modifications and various

repairs and his testimony to the fact that such expenditures were reasonable" (App. Br. 13). The motion was denied, and this is specified as error.

The witness, Raymond Martin, was the Appellee's general manager, and was personally acquainted with every part of the installation. His familiarity with the situation is not questioned, and neither is his competency as manager of the owning company to give opinion evidence as to reasonable value. See in this respect *AMCA Lbr.* v. *Buckeye-Pacific Lbr.*, 233 Or. 611, 378 P.2d 738 (1963).

Further Appellant concedes that the evidence moved against was proper so far as Martin labor, as shown by the Martin time cards, was concerned (Br. 92). Appellant says, however, that except for these time cards none of the other items in the folders (Ex. 929) furnished foundation for his testimony. A fair construction of the record as regards the testimony of this witness will lead to the conclusion that the witness was referring to invoices, time cards and other similar documents only to refresh his memory. But even so, since it is admitted that part of the testimony of this witness, the time card information, on the subject of reasonable value was not subject to being stricken, it must follow that the general motion to strike all of the testimony on the subject was properly denied. *Cameron* v. *Columbia Builders*, 212 Or. 388, 320 P.2d 251 (1958) holds that a motion to strike is properly denied under the circumstances of this case. The Court there said:

> "We think the motion to strike was properly denied for two reasons. In the first place, the motion was too broad. Even if we assume that plaintiff's objection to a portion of the testimony was well taken, other portions 'relating to the plaintiff's vehicle' were clearly admissible and were received without objection" (212 Or. at 395).

The Appellant makes further objection to the testimony of Mr. Martin as hearsay. Appellant states (Brief p. 92) that the trial Judge also recognized that much of Mr. Martin's testimony (particularly as to costs) was hearsay, but held it not prejudicial, although counsel for Appellant "pointed out" that it would be prejudicial. As to this contention of Appellant, the language of the Supreme Court in *Pitts* v. *Crane*, 114 Or. 593, 236 P. 475, is apropos:

> "Another objection relates to hearsay testimony given by Charles A. Stubbs. This witness had testified to a number of matters, including that of woodcutting by the plaintiff, Vern W. Pitts, when, in response to a question as to how he knew Pitts was cutting wood, he answered that Pitts had told him so. Were this the only testimony relating to the cutting of wood for defendant by this plaintiff, the ruling of the court in refusing to strike the hearsay testimony, upon proper motion, would be deemed serious. But, following the objectionable testimony witness testified, in effect, that he had seen Pitts cutting wood. Moreover, the record is full of competent evidence by both the plaintiff's and defendant's witnesses, and even by this defendant himself,

> that he helped to cut forty-seven tiers of wood for the defendant." (114 Or. at 602-3).

And so it is in the present case. On the reasonableness of the amounts found due by the trial Court, there was evidence produced by the witnesses, Kemp, Halverson, McManama, Wahl (for Appellant) Kintz (for Appellant) and others, and "the record is full of competent evidence by both the plaintiff's and defendant's witnesses" apart from any evidence by the witness, Raymond Martin, to support the findings.

In spite of the difficulties which counsel for Appellant seems to have had with the folders in Exhibit 929, the documents supporting the amounts of the various charges are all in the record. They are properly arranged as to the contentions and findings of the Court in Appendix B.

The trial Court was right in the ruling denying the blanket motion to strike the testimony of the witness, Raymond Martin.

CONCLUSION

The findings of fact as made by the trial Court, sitting without a jury, are in each instance sustained by competent and satisfactory evidence. The trial Judge sat through eight or nine days of trial, observing the witnesses, and taking extensive notes as the trial progressed. He made a careful personal inspection of the plant of Martin at Oakland, and personally observed the operation of the barker system

and the chipper systems. He had the arguments of the parties in lengthy briefs. He examined, considered and passed upon the Appellant's Objections to the Findings submitted. His findings and conclusions are fully supported. We do not think it true, as Appellant states in the brief that the trial Judge acted "summarily" or "failed adequately to review the evidence," but in any case the facts fully support the decision.

It is respectfully submitted that the allowance of interest on the balance found due from the due date was proper under the controlling Oregon law, that the refusal to strike the testimony of a witness had no effect on the decision, and that the Court was in all respects correct, and the judgment should be affirmed.

Respectfully submitted

IRVING RAND
GEORGE W. MEAD
Attorneys for Appellee

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

GEORGE W. MEAD
Attorney

APPENDIX A

Difficulties with the Soderhamn Debarker

Within a few days after operation commenced on June 28, 1962, the hydraulic pump inside the Barker broke (July 23, 1962), resulting in eight hours of downtime on that day (Ex. 924-B). Four days later (Friday, July 27) the Barker bearing required tightening, with eight hours downtime. The next day (Ex. 635) Martin was informed by TWX that Soderhamn personnel would be at the plant Monday. On Monday and Tuesday (July 30-31) the Soderhamn servicemen were working on the Barker.

August 9 there was downtime because of hydraulic leak in the Barker ring (Ex. 924-B). The next day (August 10) the electrical system quit working (Ex. 924-B). The next day (August 11) the Barker electrical system quit working because of oil leaks in the Barker ring (Ex. 924-B). Three days later there was a broken oil line in the Barker ring (Ex. 924-B). The following day the Barker electrical system failed (Ex. 924-B). The Barker was down from August 20 through August 25, with Soderhamn personnel working on it (Exs. 924-B, 638, 661, 662, 663, 668). Four days later (August 29) there was another breakdown in the oil line in the Barker ring (Exs. 924-B, 670). Again on each of the two succeeding days in August the hydraulic lines broke, resulting in each instance in a shutdown (Ex. 924-B).

During September, on three separate days trouble

was had with the Barker, resulting in each case in a shutdown (Exs. 924-B, 677, 638, 685).

In October trouble was encountered on six separate days (Ex. 924-B); and in November on five separate days (Ex. 924-B). Soderhamn sent to the Martin plant O'Callaghan and Roberts to install hose and replace pistons in rotor support cylinders (Ex. 706). Also on three days in December shutdown was necessitated because of Barker difficulties (Ex. 924-B).

During January, 1963, on each of seven days further difficulties with the Barker were encountered (Ex. 924-B).

Then on February 11 further difficulties were encountered, in that there was a hydraulic oil leak at the Barker and the hydraulic hose broke and the Barker ring would not go up (Ex. 924-B).

The following day the lube pump did not work, and again on February 13 would not work. The next day the Barker ring bearing froze.

These defects were reported to Soderhamn, and Soderhamn advised (Ex. 745) that the only thing in stock was a used rotor bearing that could be installed immediately, and that Soderhamn had contacted a source in Germany for a new rotor bearing to be sent air freight. This shutdown, beginning February 14, lasted until February 22.

On February 26 the Barker ring again was not working; and on the 28th the bearing races went out. This resulted in complete shutdown of the Barker for

the period from March 1 through March 15 (Exs. 924-B, 751, 753, 755, 756, 757).

By March 16 new bearings and races had been installed in the rotor. Operation commenced and the races lasted four hours (Ex. 924-B).

There was no possibility of operation from March 17 through March 28. The rotor was removed and taken to Portland to be re-machined. During the re-machining process it was discovered that the ring of the Barker was not only warped but was egg-shaped (Exs. 759, 762).

On March 28 the re-machined ring was put back into the Barker. The following day the Barker drive motor shorted out (Ex. 924-B).

Trial run of the newly re-machined rotor and check on bearing was had the first four days of April. Martin requested the presence of a Soderhamn representative for Friday, April 5, to observe the adjustment of the rotor bearing, and Soderhamn demanded "purchase order and non-cancellable check covering this expense" (Ex. 760).

Next on April 25 there developed an oil leak in the Barker ring (Ex. 924-B), and another again on the 30th.

The next month an abnormal noise developed coming from the rotor. Soderhamn was notified, and on May 15 its representative, Mr. Kornberg, sent a TWX that from information furnished him by his engineer it was impossible to ascertain the reason for the abnormal noise and only a rotor disassembly would reveal the difficulty (Ex. 769).

By May 17 the bearing had completely failed; metal was found in the oil filter (Ex. 770). A TWX to Soderhamn of May 17 notified Soderhamn that Martin had been unable to secure the recommended tolerances in the rotor bearing, and requested a representative of Soderhamn for inspection.

May 20 Soderhamn by TWX informed Martin that the rotor bearing parts were in stock and that Soderhamn would send its representative O'Callaghan down with parts on Wednesday morning (Ex. 771). The Barker ring was re-installed on May 23 (Ex. 924-B).

The Barker struggled along through June and July with difficulties in various portions of the machine, causing shutdowns on each of 13 days (Ex. 924-B).

On August 5 the lube pumps were found to be plugged with metal shavings, and a seventh bearing failure had apparently occurred (Ex. 924-B). Martin inquired of Soderhamn when a bearing assembly for replacement might be expected (Ex. 779), and when informed that balls for the bearing were enroute from the factory (Ex. 780) sent to Soderhamn a "Request that you pick up your Barker" (Ex. 781).

Soderhamn took the Barker away from the plant of Martin at Oakland (Agreed Facts, pre-trial order, R. 10) and rebuilt the machine, using races for the bearings of another design (Tr. 75) and sold the machine to a third party (R. 12).

APPENDIX B

DOCUMENTS SUPPORTING COSTS INVOLVED IN THE FINDINGS AND CONCLUSIONS

The documents supporting the various costs involved are contained in Exhibits 809 through 819; 823; 824; 915, pages 1 through 48 (attached to answers to plaintiff's supplemental interrogatories); 917; 918; 921, A through N; 925; 928, A through C; and 929. Many Exhibits are duplicates of other Exhibits. Exhibit 929 is supposed to contain a complete list of all cost Exhibits involved. All of the documents referred to below are in one or more of the Exhibits mentioned. Reference in each instance to Exhibit number will therefore be omitted.

SUPPORTING DOCUMENTS AND BREAKDOWN OF DEFENDANT'S CONTENTIONS

CONTENTION NO. 1—Barker Foundation Structure:

Martin Labor ....$ 28.88
Sutherlin Machine, materials
and labor per invoices
D 1626
D 1375
D 1428
D 1410
D 1144
D 1271
D 1271-A
D 1141
D 1141-A
D 1141-C

D 1302
D 1302-A
D 1302-B
D 1622 .... 11,580.85

Total of Contention No. 1 .... $ 11,609.73

CONTENTION NO. 2—Log Haul:

Martin Labor .... $ 5.78
Sutherlin Machine, materials
and labor per invoices
D 1201
D 1201-A
D 1201-B
D 1201-C .... $ 2,963.25

Total of Contention No. 2 .... $ 2,969.03

CONTENTION NO. 3 — Transfer Deck, Kickers and Kicker Shafts and 3 Pits:

[3-ABC] Martin Labor .... $ 53.13 [Kickers and Kicker Shafts]
[3-ABC] Northwest Machinery
Sales invoice No. 3923 .... $ 35.00 [Kickers and Kicker Shafts]
[3-D & 17] McManama & Co.,
invoice No. 218-708 .... 4,116.00 [Steel Deck]
[3-E] McManama & Co.,
invoice No. 218-717 .... 1,833.10 [Pits]
Sutherlin Machine Works,
materials and labor
per invoices
D 1559
D 1615
D 1368
D 1368-A
D 1306 [3-ABC]

D 1306-A			
D 1365			
D 1241	$ 5,392.25	[Kickers and Kicker Shafts]	
Total of Contention No. 3			$ 11,429.48

CONTENTION NO. 4—SHEER APRONS OR PLATING:

Sutherlin Machine Materials per invoices		
D 1144-A-1		
D 1144-A-2	$ 2,758.16	
Total of Contention No. 4		$ 2,758.16

CONTENTION NO. 5—BARKER REFUSE CONVEYORS:

Martin Labor	$ 65.45	
American Steel & Supply Co. materials, per invoices		
R 28159		
R 28160		
R 28161	240.49	
Industrial Electric Supply, materials, per invoices		
F-912		
F-925	90.72	
McManama & Co., invoices No. 218-704 and 218-718	4,340.30	
Total of Contention No. 5		$ 4,736.96

CONTENTION NO. 6—SAW DECK:

A—SHROUDING

Sutherlin Machine, materials and labor, per invoices

D 1508
D 1669 .... $ 1,917.06

Total Contention No. 6-A .... $ 1,917.06

B—LOG LIFTS (Including Necessary modification of saw deck to make lifts and saws an operable system)

Modification of Saw Deck
D 1877
D 1144-B-1
D 1144-A-2
D 1323
D 1680 .... $ 1,951.32
Assembly of Log Lifts
D 1864
D 1898
D 1996 .... 5,444.34

Total Contention No. 6-B .... $ 7,395.66

(Total Contentions No. 6-A and 6-B.... $ 9,312.72)

C—SINKER DECK TRANSFER CHAIN

Sutherlin Machine, labor, invoices D 1254 .... $ 56.00

Total Contention No. 6-C .... $ 56.00
D—STRUCTURE OVER SAWS
McManama & Co. quote ....$ 1,161.00

Total Contention No. 6-D .... $ 1,161.00

CONTENTION NO. 7—Hydraulic System

Mobile Oil Co., invoice No. 161106 .... $ 739.53

Brent's Exchange, materials No. 30276 No. 32510	73.36	
Component Parts Co., materials invoice No. 11796	$ 18.30	
Hydraulic & Air Equipment Co., materials, invoice No. 65444	17.41	
Fluid Air Components, Inc., materials, invoices 2351 and 2869	370.75	
Sutherlin Machine, labor and materials, per invoices D 1292 D 1292-A D 1346	$ 842.13	
Martin Labor	68.28	
Total Contention No. 7		$ 2,130.76

CONTENTION NO. 8—DEBARKER:

A—DEBARKER REPAIRS

American Steel & Supply Co., materials, per invoices R-2 3582 R-2 3583 R-2 31503	$ 264.01	
Martin Labor	427.35	
Sutherlin Machine, labor, per invoices D 1874 D 1899 D 1897 D 1869-A		

D 1869-A	1,975.20	
Total Contention 8-A		$ 2,666.56
B—RECONSTRUCTING BARKER BUILDING		
Moore Steel Service, materials, per invoices		
R-8605 7764		
R-8657 7804		
R-8757 7928		
R-8308 7529		
R-1032 1095		
R-1082 1165		
R-1061 1131		
R-1159 1211	$ 684.50	
Woodbury & Company, materials, per invoices		
E 90909		
E 90516		
E 96448	693.92	
Nicholson Mfg. Co., materials and labor, invoice 903	2,807.98	
Martin storeroom materials	27.15	
Martin Labor	2,151.77	
Crane Rental	2,131.50	
Total Contention 8-B		$ 8,496.82
C—START UP		
Martin Labor	$ 291.83	
Total Contention 8-C		$ 291.83
D—NEW DEBARKER (As set forth in Contentions, PTO)		
Nicholson Barker	$97,239.00	
As modified in Opening		

Brief, contract price of Barker never supplied	81,500.00	
Total Contention 8-D		$ 81,500.00

CONTENTION NO. 9—CONSOLE:

Moore Steel Service Co., materials, invoice No. R 6354	$ 98.30	
Sutherlin Machine, labor and materials, invoice No. R 1344	201.40	
Martin Labor	123.20	
Total Contention No. 9		$ 422.90

CONTENTION NO. 10—CONVEYORS TO HOG:

Industrial Electric Service, materials, invoice No. DO 2932	$ 7.29
Martin Labor	9.63

Sutherlin Machine, labor and materials, per invoices

D 1251
D 1609
D 1690
D 1273
D 1273-A
D 1278
D 1278-A
D 1278-C
D 1278-B
D 1278-D
D 1872-B
D 1871-B
D 1394

D 1432		
D 1432-A	$14,046.10	
Total Contention No. 10		$ 14,063.02

CONTENTION NO. 11—PAINTING BLOW PIPE:

Sutherlin Machine, labor and materials, invoice No. D 1873	$ 218.40	
Total Contention No. 11		$ 218.40

CONTENTION NO. 12—HORIZONTAL CHIPPER FEED SYSTEM:

SHAKER ROLL SECTION		
Industrial Electric Service, materials, invoice No. 00525	$ 11.82	
Martin Labor	1,388.70	
Sutherlin Machine, labor and materials, per invoices		
D 1713		
D 1713-A		
D 1713-B		
D 1724		
D 1698	$ 8,131.05	
Total Contention No. 12		$ 9,531.57

CONTENTION NO. 14—HORIZONTAL CHIPPER ROOF OVER BELT:

Sutherlin Machine, labor and materials, invoice No. D 1863	$ 558.10	
Total Contention No. 14		$ 558.10

CONTENTION NO. 15—CORE-VENEER BLOWER SYSTEM:

Archer Blower & Pipe Co., Inc.	$12,397.00	
Total Contention No. 15		$ 12,397.00

CONTENTION NO. 16—BRUSHES:

Sutherlin Machine, labor and materials per invoices D 2028 D 1879 D 1896	$ 941.38	
Total Contention No. 16		$ 941.38

CONTENTION NO. 17—WALKWAYS AND STAIRWAYS:

McManama & Co., invoice No. 218-701	$ 2,348.00	
Total Contention No. 17		$ 2,348.00

CONTENTION NO. 18—MISCELLANEOUS:

INSURANCE

Barker			
initial charge	$1,862.43		
credit	(1,439.68)	$ 422.75	
Other			
8 mos. @ 112.05		896.40	
New Zealand Policy		410.00	
Total Contention No. 18 (Insurance)			$ 1,729.15

No. 22,286

IN THE

United States Court of Appeals

For the Ninth Circuit

TRANSAMERICA EQUIPMENT LEASING CORPORATION, a Texas corporation,
Appellant,

vs.

UNION BANK, a California corporation,
Appellee.

Appeal from a Judgment of the United States District Court for the Central District of California

Honorable Manuel L. Real, Judge

APPELLANT'S OPENING BRIEF

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ERNAU-WALSH PRINTING CO., SAN FRANCISCO

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Honorable Manuel L. Real, Judge

APPELLANT'S OPENING BRIEF

I

STATEMENT OF JURISDICTION

Plaintiff Transamerica Equipment Leasing Corporation ("Transamerica") was incorporated in Texas with its principal place of business in Texas. Defendant Union Bank ("Bank") was incorporated in California with its principal place of business in California. (Admitted in Pretrial Conference Order, R 216.)* The amount in controversy, exclusive of in-

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*"Tr." refers to the Reporter's Transcript.
"R" refers to the Clerk's Record.

terest and costs, exceeds $10,000. (Complaint, paragraphs I and V, R 2-3.) The jurisdiction of the District Court was invoked under Title 28 U.S.C. Sec. 1332.

The District Court entered its judgment on April 11, 1967. A Notice of Appeal was duly filed. (R 339.) Jurisdiction is vested in this Court by Title 28 U.S.C. Sec. 1291.

II

STATEMENT OF THE CASE

This case involves a contract to make a loan. The basic issue in this appeal is whether a contract was formed. The principal controversies are whether an oral agreement was barred by the Statute of Frauds and whether a designated repayment schedule was an essential term of the contract.

These are the facts:

1. Background

(a) In August, 1963, Transamerica, which was in the business of providing financial services (Tr 19), agreed to provide funds to Ancora Corporation ("Ancora"). (Tr 21, 36, 39; Exhibit 2.) The total amount to be advanced was $600,000. Ancora's repayment obligation was evidenced in part by an equipment lease and in part by a promissory note. Both were secured by a Mortgage and by an Assignment of Runs (proceeds of sales of oil) covering six

oil wells operated by Ancora. (Exhibits 2, 4, 4A, 4B, 4C, 4D, 6; Tr 21, 36, 39.)

(b) Prior to entering into such agreement with Ancora, Transamerica commenced negotiations with Bank to borrow the funds which Transamerica, in turn, proposed to advance to Ancora. (Tr 24.) On August 21, 1963, Smith, an agent of Bank, advised Transamerica of the engineering requirements which it would be necessary for the Ancora wells to satisfy in order for Bank to lend money and Smith suggested that Eugene Fiedorek be employed to prepare the engineering report. (Tr 33-36.) Smith also stated the maximum amount which could be lent on each well and the interest rate applicable. He also advised Transamerica that it would be necessary for Transamerica to maintain a 20% compensating balance with Bank, or, in lieu thereof, to give to Bank a note for the amount of Bank's equivalent interest on such compensating balance. (Tr 33-36, Exhibits 20, 28, Tr 213-215.)

(c) On August 22, 1963, Transamerica informed Ancora that the financial transaction with Ancora would be contingent on satisfaction of the Bank's well production and engineering requirements. (Tr 36.) Transamerica and Ancora thereupon entered into a written agreement to make the loan. (Exhibit 2.) The repayment schedule attached to the agreement had previously been reviewed with Bank. (Tr. 33.) Ancora then executed and delivered to Transamerica an Equipment Lease, Note, and Mortgage and Assignment of Runs. (Exhibits 4A, 4B, 4D; 6.)

These documents provided for Ancora to make total payments of $724,932 to Transamerica, in installments at a *minimum* rate as follows:

Payment (at start of month)	Lease	Note	Each Monthly Payment	Total All Payments
1st month	$22,920.00	–0–	$22,920.00	$ 22,920.00
2d thru 6th	15,076.06	$7,843.94	22,920.00	114,600.00
7th thru 12th	12,346.06	7,843.94	20,190.00	121,140.00
13th thru 18th	9,976.06	7,843.94	17,820.00	106,920.00
19th thru 24th	7,936.06	7,843.94	15,780.00	94,680.00
25th thru 30th	6,148.06	7,843.94	13,992.00	83,952.00
31st thru 36th	4,606.06	7,843.94	12,450.00	74,700.00
37th thru 42d	3,226.06	7,843.94	11,070.00	66,420.00
43d	–0–	7,843.94	7,843.94	7,843.94
44th	5,356.06	–0–	5,356.06	5,356.06
45th thru 48th	6,600.00	–0–	6,600.00	26,400.00
			Total	$724,932.00

(Exhibits 4A, 4B, 4D.)

Ancora was also required to pay a minimum of $24,000 at the end of the initial lease term in order to continue to operate the wells. (Tr 184.)

(d) The said agreements further provided that Transamerica (or its assignees) would receive *all* of the proceeds of sale of the oil produced from the six designated wells until the total sum was paid, and would be empowered

> "to receive, collect and *hold* (all such runs) . . . and, any provision of said indebtedness secured hereinabove described to the contrary notwithstanding, (all such runs) shall be applied to the payments of the indebtedness secured hereby in such manner as the Mortgagee may elect and without any liability or responsibility on the part

> of the Mortgagee, regardless of whether such payments exceed the payments of principal and interest provided to be paid in said indebtedness secured hereby . . ." (Exhibits 4D, 11-12.)

(e) Between August 22 1963, and September 12, 1963, Transamerica notified Bank that Transamerica and Ancora had

> "agreed on a schedule of payments which will allow us to amortize two notes with the Union Bank over the desired payout period. Our attorney will contact Mr. Breakstone direct regarding the exact wording to be used in the Assignment of Production which will describe the payment sequence as concerns the two notes. . . ." (Exhibit 16.)

Copies of the proposed schedule were furnished to Bank. The Bank was also furnished with copies of the Equipment Lease, Note, Bill of Sale, Mortgage and Assignment of Runs between Transamerica and Ancora. (Exhibits 4A, 4B, 4C, 4D) and the proposed Assignment of Runs, Assignment of Lease and Chattel Mortgage between Transamerica and Bank. (Exhibits 21, 22, 23; Tr 51.)

Plaintiff concurrently began arrangements with counsel in Mobile, Alabama, to provide approving title opinions on the wells.

(f) On or shortly after September 10, 1963, Fiedorek's engineering report was delivered to Bank. Smith analyzed the report and concluded that the evaluation was acceptable and sufficient to support the proposed loan to Transamerica of $600,000, and that

it satisfied Bank's requirements for such a loan. (Tr 281-282; 285-286; 336-337.)

2. Oral Agreement

(a) On September 12, 1963, Transamerica's president met with Smith and Breakstone, Bank's attorney, in order to obtain final approval of the loan, to determine closing procedures and to prepare the necessary documentation. (Tr 48.) Breakstone reviewed and approved the aforementioned documents executed by Ancora. Breakstone also reviewed the proposed Assignment of Runs, Assignment of Lease and Chattel Mortgage from Transamerica to Bank. (Tr 283-285; 369 (with reference to Breakstone deposition pp. 14-16).) Smith did not indicate any objection to the payment schedule described in the letter of August 30, 1963. (Tr 222.)

(b) During discussion on September 12, 1963, the parties agreed on the method of computing the amount of the note in lieu of the compensating balance but they did not calculate such amount or decide whether the note should be paid in 42 equal monthly installments or in 42 installments which declined in the same proportion as the monthly payments on the $600,000 note. It was agreed that the Bank could select either arrangement. (Tr 78-80.)

(c) During the afternoon of September 12, Smith and Breakstone presented the loan to Siegel, the Bank officer authorized to approve loans. Smith reviewed with Siegel the amount, term, rate and other provisions of the proposed loan. (Tr 285-293.) Siegel

did not object to the amount or terms, but stated that since Fiedorek had been an officer of the Bank and was still retained by the Bank for certain duties, it would be necessary to obtain a concurring report from another engineer and suggested Schafer. (Tr 58; Exhibit 29.)

(d) On September 13, 1963, plaintiff's president met with Siegel. Siegel reiterated the necessity of a concurring report from Schafer. Siegel then told plaintiff's president that "if the Schafer report concurs with Fiedorek's, you have a loan." (Exhibits 25, 29; Tr 59.)

(e) Siegal orally agreed to make the loan to Transamerica subject to the sole condition that the Schafer report concur with Fiedorek's. (Exhibits 25, 29; Tr 59.)

(f) Bank immediately called Schafer and engaged him to prepare an engineering study of Ancora's wells. (Tr 60.) Transamerica proceeded to obtain the title reports, bills of sale and other documents required for a closing in Mobile, Alabama, tentatively scheduled for Monday, September 23, 1963. (Tr 60.)

3. **Written "Loan Agreement"**

(a) On September 16 and September 17, 1963, Breakstone prepared two Promissory Notes to evidence the contemplated loan from Bank to Transamerica, and he also prepared a document entitled "Loan Agreement". (Tr 381.) The Loan Agreement

was executed by authorized officers of Bank and on September 18, 1963, the said "Loan Agreement" was mailed to Transamerica together with the Promissory Notes and an Assignment of Mortgage. Transamerica was requested by Bank to hold the documents until Breakstone arrived in Dallas, Texas, on or about September 22, 1963, and to manually deliver the documents to Breakstone at that time. (Exhibit 11.)

(b) Bank had computed the amount of the note to be delivered in lieu of a compensating balance, and in the letter of September 18, 1963, Breakstone stated:

> "We calculated the fee note on the basis of what the interest would be on a loan of $120,000.00 at 5.5% and a pledge to the Bank. It is easier bookkeeping-wise for us to do it this way, and it will cost you no more. If you do not agree with the figure based on your calculations, then we can prepare a new fee note." (Exhibit 11.)

Bank's computations were satisfactory to Transamerica. (Tr 80.)

(c) The Loan Agreement expressly referred to the Assignment of Lease, Assignment of Runs and Chattel Mortgage reviewed with Breakstone on September 12, 1963, which documents, among other things, effected an Assignment of *all* of the oil runs from the six wells. (Exhibit 11, paragraph 2.) The Loan Agreement then described the amount to be loaned to Transamerica, the interest rate, the term, and the promissory notes to evidence the loan. The Loan Agreement then stated:

"both notes shall be paid monthly out of runs from the producing properties mortgaged and assigned to Bank. Application of proceeds therefrom shall be as follows: First on the monthly payment due on Note 'B', and the balance remaining to be applied first on interest and then on principal as to Note 'A', *not exceeding, however,* as to Note 'A', the monthly payment set forth in the schedule to be agreed to by and between the parties hereto. After application of proceeds as aforesaid, any excess remaining in any given month after deducting therefrom a given amount or percentage for operating expenses shall be retained by Bank and deposited in a special reserve account for Borrower, provided, however, that said reserve account shall at no time be in excess of Seventy-Five Thousand Dollars ($75,000.00)" (Exhibit 11; emphasis added.)

(d) The only effect of "the schedule to be agreed to" was to allocate the gross monthly runs among segments of the same bank loan by providing a *maximum* amount to be applied monthly to one of the notes. There would be no difference in the aggregate monthly payment to defendant or in the forty-two month total of payments. (Exhibit 11; Tr 389.)

(e) No arrangements were made for the preparation of any such schedule between September 18, 1963, and the tentative closing on September 23, 1963. Smith, who was handling the loan for Bank, did not discuss with anyone the preparation of any such schedule. (Tr 298.)

(f) An arithmetic calculation showing the application to the Bank's two notes of the *minimum* payments required from Ancora is set forth in Schedule "A" in the Appendix to this Brief. (The first payment due from Ancora is not applied to the Bank's notes pursuant to paragraph 1.1.A of Exhibit 22.) The total payments to Bank under such schedule were $680,599. The total of all the payments required from Ancora to Transamerica was $748,932. The difference of $68,333 was Transamerica's expected profit on the transaction.

4. Breach

(a) On September 19, 1963, Schafer called Smith and reported that his estimates of the primary reserves of the Ancora wells were as close to the estimates of Fiedorek as it was possible for two independent studies to come. (Tr 299.) Schafer then said that he had not had sufficient time to estimate proved secondary reserves, but he had computed possible secondary reserves. (Tr 263.) The figure was in excess of Fiedorek's. (Tr 269, 271; Exhibits 5, 17.) Schafer stated that Fiedorek's report called attention to certain assumptions and if Schafer made the same assumptions, he computed substantially the same secondary reserves as Fiedorek. (Tr 276.) Schafer had not completed his report with respect to secondary reserves when he called Smith. (Tr 267.) Schafer told Smith that since his report was not complete he had no opinion on whether he concurred or did not concur with Fiedorek. (Tr 270.)

(b) Smith had not previously considered the significance of the secondary reserves in the Fiedorek report. When they were called to his attention by Schafer, he changed his mind as to the desirability of the loan. On September 19, 1963 Smith told Transamerica that Bank could not make the loan unless the Schafer report was modified. (Exhibit 25, p. 2; Tr 302, 374.)

(c) On September 20, 1963, Transamerica called Breakstone and discussed the situation with him. Breakstone foresaw difficulties for the Bank in withdrawing from the loan commitment. (Exhibit 25.) After the conversation with Transamerica, Breakstone called Siegel and advised him that litigation threatened in connection with the loan. (Exhibit 29.) Plaintiff had made no threat of litigation. (Exhibit 25.) But Siegel, having been advised that there had been a threat, directed that the Bank would not make the loan "under any circumstances." (Exhibit 29; Tr 358.) On September 20, 1963, Transamerica was advised that the loan would not be made. Thereafter, Transamerica received Bank's letter of September 18, 1963, and the Loan Agreement.

(d) The loan was not made.

III

STATEMENT OF THE QUESTIONS PRESENTED

1. Was the oral agreement of the parties of September 13, 1963, barred by the Statute of Frauds?

2. Was the schedule of the maximum amount to be applied to one of the notes, thus allocating an agreed upon payment between different segments of the same loan, an "essential term" of the loan agreement?

3. Was the loan agreement executed by Bank on September 18, 1963, a contract or merely an offer to make a contract which could be withdrawn by Bank before it was executed by Transamerica?

4. Did the Schafer report concur with the Fiedorek report and, if it did not, was nonconcurrence excused because of the Bank's breach?

5. Did the Court err in making certain findings of fact?

IV

SPECIFICATION OF ERRORS

1. The Court erred in concluding, as a matter of law, that the oral agreement between the parties was barred by the Statute of Frauds.

2. The Court erred in concluding, as a matter of law, that the parties had not reached an agreement on an essential term of their contract.

3. The Court erred in concluding, as a matter of law, that certain agreements constituted an offer which could be withdrawn and not a binding contract.

4. The Court erred in concluding, as a matter of law, that the performance by plaintiff of conditions precedent to the contract were not excused by defendant's prior breach.

5. The Court made seven findings of fact which were not supported by any substantial evidence and which were grossly erroneous:

(a) The Court erred in its finding that the terms and conditions of the loan transaction were to be reduced to writing and said writing was to constitute the agreement of the parties with respect to the subject matter thereof. (Finding XI(a).)

(b) The Court erred in its finding that the parties did not agree upon "the terms and conditions for the repayment of the loan" and expressly reserved "such terms and conditions for repayment" for future negotiations and agreement. (Finding XIV.)

(c) The Court erred in its finding that the Schafer report did not concur with the Fiedorek report. (Finding XVII.)

(d) The Court erred in its finding that the Schafer report was required to satisfy the Bank's loan standards. (Finding XI(b).)

(e) The Court erred in its finding that the plaintiff was not committed to purchase oil well equipment or lend sums of money to Ancora. (Finding XIX.)

(f) The Court erred in its finding that the agreements of the parties were "offers". (Finding XI.)

(g) The Court erred in its finding that the repayment schedule furnished to Bank between August 22, 1963, and September 12, 1963, was only a schedule of "lease payments" (rather than lease and note) and that the first and last *five* payments were omitted (rather than the last *three* payments). (Finding IX.)

V

ARGUMENT

1. THE ORAL AGREEMENT OF THE PARTIES IS NOT BARRED BY THE STATUTE OF FRAUDS.

The Court determined, as a conclusion of law, that:

> "In the event any verbal agreement was made or entered into by and between plaintiff and defendant on September 12, 1963, or September 13, 1963, any such agreement would be barred and would be unenforceable by reason of the statute of frauds." (R 321.)

The Court erred for three reasons:

a. Under California law, any right to rely on the Statute of Frauds was waived by defendant and could not be asserted by the trial Court judge on defendant's behalf.

b. There were written memoranda which satisfied the requirements of the statute.

c. The trial Court totally misapprehended the effect of the evidence before it.

a. An oral agreement under the statute of frauds is voidable, not void. The objection may be waived. It was waived in this case.

In paragraph III of the First Cause of Action in this Complaint (R 3), in plaintiff's pretrial Memodandum of Contentions of Fact and Law (pp. 18-19), in the Pretrial Conference Order (R 217-218), in its opening statement (Tr 12), and immediately upon the conclusion of its case (Tr 394), plaintiff asserted its intention to rely on the oral agreement. Evidence was

introduced, without objection and without any motion to strike, proving the existence of such an oral agreement made on September 13, 1963.

Such evidence consisted, in part, of the following:

(i) Testimony of C. Lee Chipman. (Tr 59.)

(ii) Testimony of Harold P. Smith. (Tr 293.)

(iii) Exhibit 29, p. 1. (Admitted Tr 306.)

(iv) Exhibit 25, p. 2. (Admitted Tr 77, 372.)

At the conclusion of plaintiff's case and at the conclusion of the trial the Court made the first and only references to the Statute of Frauds by inquiring whether it was a bar to the alleged oral agreement. (Tr 402, 431.) The judge's last words at the trial were:

> "On the basis of the evidence of what Mr. Chipman testified to and what Mr. Breakstone testified to you might do some research on the statute of frauds." (Tr 449.)

Defendant, however, never once raised the point, nor moved to strike any of the evidence which proved the oral agreement, nor even alluded to the matter in its post trial brief. (R 275.)

The trial Court, in the Memorandum entered March 21, 1967 (R 298), said the "purported oral 'Lease Agreement' of September 13, 1963, is barred by the Statute of Frauds" and it subsequently made the conclusion of law quoted above. Since it eliminated the issue as a matter of law, the Court did not make any finding of fact with respect to the existence of the oral agreement.

Under California law, when proof of an oral contract is admitted without objection, or without any motion to strike, the right to rely on the statute of frauds is waived.

In *Pao Ch'en Lee v. Gregoriou* (1958) 50 Cal.2d 502, the Court noted:

> " . . . it is settled that (1) a defendant waives his right to rely upon any provisions of the statute of frauds (Civ. Code, § 1624) by failing to (a) demur to the complaint, (b) object to the introduction of testimony to prove the oral agreement at the time of trial, or (c) make a motion to strike such testimony." (506.)

See also:

Howard v. Adams (1940) 16 Cal.2d 253, 257, 105 P.2d 971;

McKinley v. Lagae (1962) 207 Cal.App.2d 284, 293;

Sloan v. Hiatt (1966) 245 Cal.App.2d 926;

Nunez v. Morgan (1888) 77 Cal. 427, 432, 19 P. 753;

Coleman v. Satterfield (1950) 100 Cal.App.2d 81, 83, 223 P.2d 61;

Aaker v. Smith (1948) 87 Cal.App.2d 36, 43, 196 P.2d 150;

Ingraham v. Smith (1948) 83 Cal.App.2d 807, 808, 189 P.2d 721.

In *Bank of America v. Hutchinson* (1963) 212 Cal. App.2d 142, the plaintiff referred to an oral agreement in the pretrial order and during the trial. After the trial was concluded, the trial judge inquired

whether either counsel had looked into the bearing of the Statute of Frauds on the case. Both counsel indicated they had not looked into the subject. Two weeks later, the defendant, claiming the Statute of Frauds, moved to strike all testimony and evidence relating to the oral representations.

The Court held the Statute of Frauds could not be asserted as a bar.

> " 'Since the statute of frauds relates only to a remedy, and not to a right, a defense based on its provisions can be waived. For instance, where the defendant has permitted parol proof of the existence of a verbal contract within the scope of the statute to be admitted without objection or exception, he will, as a general rule, be deemed to have waived the defense of the statute, and a belated motion to strike such oral evidence, made at a subsequent stage of the trial, should be denied.' " (149.)

Since defendant in this case did not assert the bar of the Statute of Frauds it was waived and the Court cannot present the claim on defendant's behalf. Defendant, with its eyes open, permitted extensive testimony and evidence to be admitted showing an oral agreement. Whether it did so deliberately for reasons of trial strategy or whether it did so through neglect is of no consequence. The trial Court has no authority to thrust on the Bank an optional remedial defense which the Bank did not elect to employ. The law is clear that the defense, not used, is waived. The Court's conclusion of law treats the Statute of Frauds

as a matter of substantive right which is not subject to waiver. In this the Court was plainly wrong.

The Court recognized that there might have been an oral agreement. Its conclusion used the language "In the event any verbal agreement was made. . . ." But the Court, relying improperly on the Statute of Frauds, declined to make any finding of fact on the ultimate issue of whether there actually was an oral agreement. That issue should have been determined and the evidence indicates it should be determined in plaintiff's favor. Plaintiff's motion for New Trial was based on this issue. (R. 324.) The Motion was improperly denied (R 337.) A new trial should be granted.

b. There were written memoranda in this case which satisfied the statute of frauds.

The requirements of the statute may be satisfied by memoranda executed subsequent to the agreement, or which are embodied in several papers or which refer to other documents which are fairly connected; the memoranda need not be delivered nor even to have been intended as memoranda of an oral contract:

Simmons v. Birge Co. (1943) 52 F.Supp. 629;
Mangini v. Wolfschmidt Ltd. (1961) 192 Cal. App.2d 64;
Bowens v. Jung (1944) 57 F.Supp. 701;
Searles v. Gonzalez (1923) 191 Cal. 426;
Quan Shew Yung v. Woods (1963) 218 Cal. App.2d 506.

In *Straus v. De Young* (1957) 155 F.Supp. 215, Judge Jertberg reviewed the California law on the

nature of the writing required under the Statute of Frauds and concluded:

> "That a contract may consist of several documents . . .
>
> "That it is not necessary that the party to be charged sign all of the documents comprising the contract, if one of the documents in the series, or all of the documents taken together set forth clearly and completely all of the essential elements of the contract, except those which may be reasonably implied as being present and inherent in the deal . . . ."
>
> "The document signed does not need to contain all of the terms of the contract; and the document signed does not need to be addressed to the other party." (218.)
>
> * * * * *
>
> "A memorandum signed by the party to be charged which forms no part of the contract, but which recognizes the existence of a contract, is a sufficient memorandum. . . ." (218-219.)

In this case the oral agreement was established by the Bank's signed memorandum (Exhibit 29) as well as by the Lease Agreement, (Exhibit 11) signed by the Bank, which referred to the documents identified as Exhibits 21, 22, 23 and 4A, 4C, 4D and 4E. These papers showed an agreement (conditioned on a concurring engineering report) to lend $600,000, the repayment obligation to be evidenced by a note for $11,500, bearing no interest, and another note for $600,000 bearing interest at 7%, both secured by six designated wells, and payable in 42 installments,

out of the runs from such wells, with minimum payments as set forth in Exhibits 22, 4A, 4B and 4D.

c. **The trial court misapprehended the evidence bearing on the oral agreement.**

The Court's attitude toward the oral agreement issue was materially affected by a gross misapprehension of certain testimony.

The Court, during argument, repeatedly commented that Transamerica's president had testified that no oral agreement had been made. The Court said:

> "Your client testified that when he left the bank on the 13th there was no agreement as to a loan, that he didn't think he had an agreement with the bank at that time. He testified to that directly, counsel." (Tr 418, 419.)

The Court later said:

> "[T]here was no agreement by your client's own testimony when he left on September 13th." (Tr 432.)

There was remonstrance:

> "Mr. Lempert: Your Honor mentioned some direct testimony of Mr. Chipman that I have no vivid recollection of.
>
> The Court: I have a very vivid recollection because that is one of the issues here. When he left on the 13th he had no agreement for a loan." (Tr 419.)

A searching analysis of the transcript will show that the testimony repeatedly cited and relied on by the Judge did not exist. Mr. Chipman never said any-

thing remotely resembling what the Court attributed to him.

The Court made its decision in this case believing that Chipman had given testimony which he did not give. Its decision therefore was based, in part, not on evidence but on myth.

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2. THE WRITTEN LOAN AGREEMENT DID NOT RESERVE ANY "ESSENTIAL TERMS" OF THE CONTRACT FOR FUTURE NEGOTIATION.

Evidence was introduced showing that there was a written agreement, as well as an oral agreement. The Court determined, as a conclusion of law, that:

> "The written loan agreement, dated September 18, 1963, is not binding upon the parties because it reserves for future negotiation and agreement of the parties the terms and conditions upon which the subject loan would be repaid, which said terms and conditions of repayment were essential terms of the contemplated loan transaction." (R 321.)

The Court erred; there was only a single matter which the written Loan Agreement (R 6; Exhibit 11) appeared to leave for future determination, and that was not an "essential term" of the contract.

The Loan Agreement, after it recited in paragraph 8 that the bank would receive all of the Ancora runs each month, stated that the gross runs would be applied first to the compensating balance note and the remainder to interest and principal on the other note

"not exceeding, however . . . the monthly payments set forth in the schedule to be agreed to by the parties." The balance went to a reserve.

The Court's conclusion of law is rooted in the assumption that an internal allocation of the Bank's gross monthly payments, which neither affects the amount the Bank is entitled to receive each month, nor the total amount the Bank is to receive, is an "essential term."

> "Mr. Lempert: Do I understand your Honor feels that that difference, which does not affect the total amount the bank receives (nor)* the Bank's total compensation for the loan (and) which only affects an allocation between two pieces of the same transaction is such a material point, such a significant and substantial point that no contract exists?
>
> The Court: Yes, certainly it is. Yes, it is." (Tr 445.)

The trial Court's view is not the law.

a. Essential terms are those without which a contract is unintelligible and unenforceable.

In *City of Los Angeles v. Superior Court* (1959) 51 Cal.2d 423, the Supreme Court of California said:

> "The contract is claimed to be void because it contains promises to agree in the future. The general rule is that if an 'essential element' of a promise is reserved for the future agreement of both parties, the promise gives rise to no legal obligation until such future agreement is made.

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*Words in parentheses are corrections of the Reporter's Transcript.

. . . The enforceability of a contract containing a promise to agree depends upon the relative importance and the severability of the matter left to the future; it is a question of degree and may be settled by determining whether the indefinite promise is so essential to the bargain that inability to enforce that promise strictly according to its terms would make unfair the enforcement of the remainder of the agreement. . . . Where the matters left for future agreement are unessential, each party will be forced to accept a reasonable determination of the unsettled point or if possible the unsettled point may be left unperformed and the remainder of the contract be enforced." (433.)

In the case of *Wong v. Di Grazia* (1963) 60 Cal.2d 525, the Supreme Court said:

"A minor possible ground of disagreement in an otherwise complete agreement will not render the agreement uncertain. . . . As this court held in *Roy v. Salisbury* (1942) 21 Cal.2d 176, 184 '. . . the law does not favor but leans against the destruction of contracts because of uncertainty; and it will, if feasible, so construe agreements as to carry into effect the reasonable intentions of the parties if that can be ascertained.'" (539.)

Mancuso v. Krackov (1952) 110 Cal.App.2d 113 involved a sale where the prices and quantities were left contingent on later determinations. The court noted:

"It is only that the essentials of the contract must have been agreed upon and be ascertainable. . . . Furthermore, it is a well established principle of law that that which can be made certain is

certain. (Civ. Code § 3538; *Tuck v. Gudnason,* 11 Cal.App.2d 626.)

"Applying the principles above stated to the facts shown by the record it is readily apparent that there was ample evidence to support the findings of the jury. It was a business arrangement, worked out in as much detail as was then possible; the items to be included in the bottling costs were ascertained at the October meeting of the parties. All that remained was the computation thereof, which would be made at a later date when the desired data would be available, which it ultimately was." (115.)

Burrow v. Timmsen (1963) 223 Cal.App.2d 283 involved the interpretation of an agreement to obtain a loan. The Court said:

"We have concluded that the agreement is not so uncertain as to be incapable of enforcement. The modern trend of the law is to favor the enforcement of contracts, to lean against their unenforceability because of uncertainty, and to carry out the intentions of the parties if this can feasibly be done. Neither law nor equity requires that every term and condition of an agreement be set forth in the contract. (*King v. Stanley,* 32 Cal.2d 584; *Martin v. Baird,* 124 Cal.App.2d 598. . . . The terms of the deferred payments are that plaintiff would execute a note for $37,000.00, bearing 7 percent interest, and secure payment with a trust deed, payments to be made at the rate of $300.00 per month. Defendants contend there is uncertainty due to the failure to state the time period of the note, whether the note will be negotiable, whether defendants would be en-

titled to attorney's fees in an action to collect on the note, who will be the trustee, whether there are to be covenants against waste, who has the obligations of paying taxes, what the defendants' remedies would be upon default, and what powers the trustee would have.

"We do not regard any of these omissions of detail as a defect which necessarily renders the agreement unenforceable." (288-289.)

"The essentials of the agreement are the amount of the debt and the terms of payment, including the interest agreed upon." (288-289.)

See also *Stockwell v. Lindeman* (1964) 229 Cal. App.2d 750, which held that an agreement referring to a loan not to exceed $80,000, with interest not to exceed 7.5% and payable "at such terms and upon such conditions as are required by the lender making such construction loan" was not void for uncertainty. The Court further considered an option which described the property, the purchase price, down payment, monthly payments, interest rate and term, but which then stated: "balance of terms to be set out in (another document)." The Court noted:

"True, other items could well have been provided for, such as, whether the sale is to be on a written contract of sale or by the delivering of a deed with the seller taking back a purchase money trust deed securing the remainder of the purchase price, or whether the remainder is to be secured by a mortgage on the subject property. But none of these details are necessary or vital to its enforcement as a valid contract.

"What effect then does the addition of 'balance of terms to be set out in said option' have upon the enforceability of this option provision? Does it render the contract to give an option 'through this escrow' void and unenforceable? We conclude that it does not. If the parties to the escrow fail to agree upon any further terms, the option to be delivered in escrow need contain only the details which are spelled out since they cover the essential ingredients of an unenforceable option." 755-756.)

b. Absence of a schedule of maximum payments does not render the Loan Agreement unenforceable.

On its face, the only matter which the Loan Agreement left open was an internal allocation, not the amount of the gross monthly payments to the Bank.

The Ancora agreements with Transamerica (Exhibits 4A, 4B, 4C and 4D) assigned to Transamerica, as mortgagee, all of the runs from the six Ancora wells. As previously noted, the mortgagee was authorized to retain and apply all of such runs to the Ancora obligation even if the runs exceeded the amount of the specified minimum payment.

The Loan Agreement, in paragraph 2, and in the Assignment which accompanied the transmittal of the Loan Agreement to Transamerica (Exhibit 11), incorporated by reference the assignment to the Bank of these runs and the assignment to the Bank of the rights of mortgagee under the Ancora mortgage. Paragraph 8 of the Loan Agreement noted that the designated runs were the source for repayment of the bank loan. Breakstone also testified as follows:

"Q. Were you aware that all the money coming to Transamerica in this transaction available for repayment of the bank loan would be the money coming from the Ancora promissory note (and lease)?

A. It was my understanding all of the money was to really come from the runs of the oil.

Q. And that was the money that was going to be employed to repay the bank?

A. That is correct." (Tr 389-390.)

The Loan Agreement and the documents referred to in paragraph 2 (identified as Exhibits 21, 22 and 23) confirm in the Bank the right to receive *all* of the runs. The same documents unquestionably show the minimum monthly payment the Bank must receive. That is the essential and enforceable right.

c. The parties treated the schedule as a matter of no importance.

Consideration must be given, in determining whether a term is essential, to the apparent contractual intentions of the parties. This the Court did not do.

It is obvious that the Bank was not concerned about any schedule of maximum payments. Smith testified he didn't discuss the preparation of such a schedule with anyone. (Tr 298.) Breakstone testified that he was ready to close the loan on Monday, September 23, 1963. As of Friday, September 20, he had not prepared any schedule. Exhibit 29 was a comprehensive and detailed memorandum on the loan prepared for the Bank's files. It contains not a syllable about any such schedule.

There were two significant and lengthy telephone calls between the parties on September 19, 1963 and September 20, 1963. Exhibits 24 and 25 are transcripts of the conversations. No one breathed a word about any schedule. Breakstone, an attorney, discussed the Bank's contractual liability. He never alluded to any schedule which had been left for future agreement. In none of the contemporaneous memoranda, in none of the telephone calls, in none of the letters, in none of the communications, in none of the testimony, in nothing, is it indicated that the Bank was considering the negotiation of any schedule.

Plaintiff argued, of course, that the reason for the silence was that the schedule *had* been negotiated. It was simply the sums set out in Exhibit 22 which required only some arithmetic to produce the table attached as Schedule "A" to the Appendix to this Brief. The Court did not accept this conclusion. But the indifference of the parties to the negotiation of any schedule could only mean that the matter had been resolved (as it was) or that, as an internal allocation, it was of no consequence.

---

3. THE TRANSACTION BETWEEN THE PARTIES ON SEPTEMBER 13, 1963, WAS AN AGREEMENT NOT AN OFFER WHICH COULD BE WITHDRAWN.

The Court categorized the proceedings on September 12, 1963, and September 13, 1963, as constituting an offer. (R 316.) The Court also categorized the Loan Agreement as the written memorial of such offer

and it therefore concluded that the Loan Agreement could be withdrawn before plaintiff assented thereto. (R 320-321.)

There was no basis for the Court's categorization and, indeed, the conclusion is opposite to what defendant itself admitted:

> "The (Loan Agreement) was prepared, not to bind the plaintiff, but to bind defendant . . . . So far as plaintiff is concerned, its signature is a superfluity." (R 244, Defendant's Supplemental Memorandum of Contentions of Fact and Law.)

If the Bank, on September 13, 1963, when it said that if the engineering reports concur you have a loan, was merely making an offer, the facts show conclusively that it was accepted by plaintiff on the spot. (Tr 58.)

The Court found, as one of the terms of the alleged "offer" that "All of the terms and conditions of the contemplated loan transaction . . ." were to be reduced to writing. Defendant argues that mutual execution of the writing was therefore an indispensible condition to any contract. The contention is wrong for two reasons:

(a) The evidence does not support the finding.

(b) There is no finding that the parties did not intend to be bound in the absence of a writing.

a. The writing was first discussed after the agreement was made.

The only evidence with respect to the preparation of a written agreement was that of Breakstone. He

said that *after* Siegel had committed the Bank to the loan, then Breakstone discussed closing mechanics with plaintiff and at that time said there would have to be a loan agreement. (Tr 380.)

It is obvious from the context that the writing was to be a written memorial of the existing oral understanding.

Moreover, as the Court repeatedly noted, Breakstone had no independent authority to make any agreements for Bank.

> "The Court: It is all right. Counsel, I think it is unimportant. This man is not the man who set the condition. All this man does is review the documents. Your client knew it." (Tr 389.)

The essence of plaintiff's case is that after all of the essential matters had been reviewed by Smith and Breakstone and presented to the Bank's senior executive vice-president who had authority to bind the Bank, the Bank agreed to make the loan. Subsequent comments by Breakstone, the Bank's attorney, who had no authority to bind the Bank did not change the oral agreement.

b. Even if parties intend to reduce their agreement in writing they can be bound to their contract without the writing.

The Court's position seems to be based on the notion that if the parties to an oral agreement intend to reduce their agreement to writing then, until the writing is duly executed, the oral agreement merely has the status of an offer. This is not the law.

In *American Areo. Corp. v. Grand Central Aircraft Co.* (1957) 155 Cal.App.2d 69, the Court noted:

> "It was part of the understanding of the parties that their oral agreement should be reduced to writing, signed by them, and delivered. The oral agreement, as made, was not reduced to writing. New terms were added in the writing, and it was never signed by American or delivered. The result was that the oral agreement remained binding (*Johnson v. 20th Century-Fox Film Corp.,* 82 Cal.App.2d 796, 820 [187 P2d 474]; *Columbia Pictures Corp. v. DeToth,* 87 Cal.App.2d 620, 629 [197 P2d 580]), and the proposed written contract was of no force or effect." (82-83.)

In *Columbia Pictures Corp v. DeToth* (1948) 87 Cal.App.2d 620, 197 P.2d 580, the Court said:

> "The cases are legion to the effect that when the respective parties orally agree upon all of the terms and conditions of an agreement with the mutual intention that it shall thereupon become binding, the mere fact that a formal written agreement to the same effect is to be prepared and signed does not alter the binding validity of the oral agreement. . . .
>
> "It is, of course, likewise the law that if it is the intention of the parties that before a contract shall exist between them, the terms of the contract are to be reduced to writing and signed by them, a complete or binding contract does not arise until a writing evidencing the terms of the agreement has been executed. . . .
>
> "Whether it was the mutual intention of the parties that the oral agreement should be binding *eo instante* is to be determined by the surrounding

facts and circumstances of a particular case and is a question of fact for the trial court." (629.)

In the present case, of course, the Court never did make a determination whether there was an oral agreement because, through its error in applying the Statute of Frauds, it never reached that issue.

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4. **NONPERFORMANCE BY PLAINTIFF OF ANY CONDITIONS PRECEDENT WAS EXCUSED BY DEFENDANT'S BREACH.**

The Court determined, as a purported finding of fact, that two conditions precedent to the contract had not been performed. (R 319, 320.) The first condition was that the Schafer report "concur" with the Fiedorek report. The second condition was that Bank be furnished with an approving title opinion.

On September 19, 1963, the Schafer report was not complete and it neither concurred nor failed to concur with the Fiedorek report. (Tr 267-270.) On September 19, 1963, the Alabama attorney reviewing title was in the process of preparing his opinion. Closing was scheduled for September 23, 1963. (Tr 60.)

Before the work required to meet either condition could be completed, defendant gave notice that it would not make the loan "under any circumstances". (Tr 358; Exhibit 29.) The Court expressly found that:

> "At all times since September 20, 1963, defendant has failed and refused to make the contemplated loan to plaintiff." (R 319; Finding XVI.)

Since the Bank gave notice of its refusal to make the loan on September 19, 1963, plaintiff's obligation to perform the conditions precedent on September 23, 1963, was excused.

As noted by *Williston on Contracts* (2d Ed.) Sec. 699:

> "It is an old maxim of the law that it compels no man to do a useless act, and this principle has been applied to the case of a conditional promise. If the promisor is not going to keep his promise in any event, it is useless to perform the condition and the promisor becomes liable without such performance. So if before the time for the performance of a condition by a promise, the promisor leads the promisee to stop performance by himself manifesting an intention not to perform on his part, even though the condition is complied with, 'it is not necessary for the first to go further and do the nugatory act.'"
>
> See: *Rice v. May* (9th Cir. 1956) 231 Fed.2d 389.

The Court failed to recognize that performance could be excused by defendant's breach.

> "The Court: Don't you have to show that your client was ready, willing and able to perform the conditions?
>
> Mr. Lempert: Yes.
>
> The Court: Or that they were (excused)?
>
> Mr. Lempert: We showed both of those things, your Honor.
>
> The Court: The fact that the bank did not perform is not an excuse for your proceeding.
>
> Mr. Lempert: The fact that the bank gave us notice of anticipatory breach then . . . would have

excused our condition to proceed. Moreover, the actual time for performance being on the 23rd, Mr. Riddick did not go forward to consummate the things he was working on on the 19th and the 20th. Up to that time he had received all the title opinions from other counsel. He had been instructed to get a release from Jett and it appeared he was getting a release from Jett. There was no reason to believe he could not deliver the opinion on the 23rd. He wasn't asked to because it didn't take place on the 23rd.

The Court: It is your lawsuit, not mine." (Tr 201-202.)

The Court erred, and as a result of its error of law, it made an improper finding. It should have held, consistently with its finding XVI, that performance of the conditions by plaintiff on September 23, 1963, was excused by defendant's prior refusal to proceed.

---

5. CERTAIN FINDINGS WERE GROSSLY ERRONEOUS.

a. **Finding XI(a)**:

The finding that a term of the "offer" was that the writing constitute the agreement is improper for the reasons set forth in paragraph 3(a) of this Brief.

b. **Finding XIV**:

The finding that the parties *expressly reserved* "terms and conditions" of the loan for future agreement is wrong.

As noted in paragraph 2 of this Brief, there was only one term in the Loan Agreement which was "ex-

pressly" reserved for future agreement. Evidence was introduced to show that in fact the reference was actually to an allocation between the two notes. (Tr 79; 384.) It was shown that the Bank had the option to select whether the compensating balance note would be paid in 42 equal installments or in 42 declining installments. Until the choice was made it was not practical to compute the monthly payments allocable to the $600,000 note although the total required monthly payments would remain constant. On September 18, 1963, Bank made its election to have the compensating balance note paid in equal installments. (Exhibit 11.) The schedule then became a matter of pure arithmetic computation as set forth in Schedule A in the Appendix.

Breakstone and Smith both testified that they had no objections to the mortgages, assignments, leases and other documents, which expressly included the precise minimum monthly amounts to be paid. Breakstone testified that on September 12, 1963, he thought there *might* have to be some changes or interlineations. (Tr 367.) On September 13, 1963, the loan was passed upon by the Bank's authorized officer and there was no further reference by anyone as to any possible changes or interlineations.

c. **Finding XVII**:

The finding that the Schafer report did not concur with the Fiedorek report is unsupportable. The evidence was that Schafer did not complete his report and that he had no opinion whether it concurred or

did not concur. (Tr 270.) No one could determine whether there was nonconcurrence because the report was never finished.

d. Finding XI(b):

The finding that Schafer's report was required to satisfy the Bank's loan standards is totally unsupported nor fairly deductible from the Loan Agreement. Schafer's report was only intended as a "me too" report (Tr 255), which was to concur or not concur in the Fiedorek report. The Fiedorek report had already been evaluated and that report met the Bank's lending standards. (Tr 281-282, 285-286, 336-337.) The Bank's standards did not change. If the Schafer report concurred in the Fiedorek report there was no basis for further anlysis of the Bank's standards. The language used in the Loan Agreement only defines the effect of concurrence. It does not set up a new standard which Schafer's report was required to meet.

e. Finding XIX:

The Court made a finding that there was no binding agreement between Transamerica and Ancora. This was not an issue litigated in the case. The Court had announced early in the trial that it would not consider any consequential damages arising out of other agreements or business relationships. (Tr 189.)

There was evidence that on September 13, 1963, Chipman told Bank that he was not "personally committed" to Ancora. (Tr 378.) When the same point was stated more generally in a fashion that might have applied to Transamerica there was an objection:

"Mr. Smith: In view of the way he appeared either Breakstone or myself, I can't remember which, asked him if he were working under a commitment to Ancora. He answered no.

Mr. Lempert: May that be stricken, your Honor? I do not see the relevancy of that in any way, shape or form as to whether or not Mr. Chipman's legal conclusion as to whether or not he had a commitment or not has any bearing on this particular action.

The Court: I consider it admissible as to the frame of mind of Mr. Chipman as to the relationship with Ancora." (Tr 317.)

Exhibit 2 is clear evidence that notwithstanding what Chipman's state of mind might have been, there was a binding agreement between Transamerica and Ancora.

f. **Finding XI**:

The Court's finding that the events on September 13, 1963, merely constituted an offer were discussed in paragraph 3 of this Brief. The determination is unsupported and, at best, is based on a mistaken view of the extent to which the Court could consider the oral agreement.

g. **Finding IX**:

The finding relates to the content of Exhibit 16 which sets forth a repayment schedule per well. The finding misreads some of the content of the letter in that it sets forth 44 of the 48 Ancora lease and note payments rather than 42 of the 48 payments.

h. Finding XV:

The finding that the repayment schedule incorporated in the documents could not repay the contemplated bank loan is utterly mistaken.

Schedule "A" in the Appendix shows how the loan is repaid pursuant to the *minimum* payment schedule. There is a balloon requirement of about 1½% at the end of the term. It is obvious this small amount is within the contemplated range of the runs which would be received by the Bank over the minimum and either allocated to the note or to the reserve.

According to the Fiedorek report, which the Bank had received, reviewed and approved before preparation of the Loan Agreement, and upon which the parties predicated their computations, the oil runs, during the years September 1, 1963, to September 1, 1967 (48 months), were estimated to total $850,840, as follows:

Year Beginning September 1	Gross Revenue After Production Taxes
1963	$339,063
1964	238,791
1965	160,669
1966	112,417
	$850,940

(Exhibit 5, p. 3, column 4.)

Fiedorek noted that in order to determine the runs for 42 months the runs for the last year are prorated. The total for such period was about $795,000. (Tr 249.) The income thus estimated by Fiedorek, upon which the Loan Agreement was predicated, substan-

tially exceeded the amount required to service the contemplated bank loan ($669,049).

VI

CONCLUSION

The Court misapplied the law in construing the oral agreement of the parties and misconstrued the language and effect of the written Loan Agreement.

Wherefore, plaintiff respectfully requests that the judgment of the Court below should be reversed.

Dated, San Francisco, California,
July 24, 1968.

Respectfully submitted,
ARTHUR J. LEMPERT,
Attorney for Appellant.

CERTIFICATE OF COUNSEL

I certify that in connection with the preparation of this brief I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and, in my opinion, the foregoing brief is in full compliance with these rules.

ARTHUR J. LEMBERT,
Attorney for Appellant.

(Appendix Follows)

Appendix

SCHEDULE A

MINIMUM
REPAYMENT SCHEDULE

Total Payment	Applied to $11,550 Note	Net Payment	Applied to $600,000 Note Principal	Interest	Bala
$22,920	$275	$22,645	$19,145	$3,500	$580,
22,920	275	22,645	19,257	3,388	561.
22,920	275	22,645	19,369	3,276	542,
22,920	275	22,645	19,482	3,163	522,
22,920	275	22,645	19,596	3,049	503,
20,190	275	19,915	16,980	2,935	486,
20,190	275	19,915	17,079	2,836	469,
20,190	275	19,915	17,179	2,736	451,
20,190	275	19,915	17,279	2,636	434,
20,190	275	19,915	17,380	2,535	417,
20,190	275	19,915	17,481	2,434	399,
17,820	275	17,545	15,223	2,332	384,
17,820	275	17,545	15,302	2,243	369,
17,820	275	17,545	15,391	2,154	353,
17,820	275	17,545	15,481	2,064	338,
17,820	275	17,545	15,571	1,974	322,
17,820	275	17,545	15,662	1,883	307,
15,780	275	15,505	13,713	1,792	293,
15,780	275	15,505	13,793	1,712	279,
15,780	275	15,505	13,874	1,631	265,
15,780	275	15,505	13,955	1,550	251,
15,780	275	15,505	14,036	1,469	237,
15,780	275	15,505	14,118	1,387	223,
13,992	275	13,717	12,412	1,305	211
13,992	275	13,717	12,485	1,232	198
13,992	275	13,717	12,558	1,159	186
13,992	275	13,717	12,631	1,086	173
13,992	275	13,717	12,705	1,012	160
13,992	275	13,717	12,779	938	148
12,450	275	12,175	11,311	864	136
12,450	275	12,175	11,377	798	125
12,450	275	12,175	11,444	731	113
12,450	275	12,175	11,510	665	102
12,450	275	12,175	11,577	598	90
12,450	275	12,175	11,645	530	79
11,070	275	10,795	10,333	462	68
11,070	275	10,795	10,393	402	58
11,070	275	10,795	10,454	341	48
11,070	275	10,795	10,515	280	37
11,070	275	10,795	10,576	219	26
11,070	275	10,795	10,638	157	16
16,681	275	16,406	16,311	95	-
	$11,550	$669,049	$600,000	$69,049	

SCHEDULE B

Pages of Transcript where Exhibits Identified and Received or Rejected

No.	Page of Transcript: Identified	Page of Transcript: Received or Rejected
	26	27
	26	36
	26	39
	39	84
	39	40, 84
	39	40, 84
	39	40, 84
	251	251
	26	43
	26	41
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	26	47
	26	47
	26	84
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	26	85
	26	85
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	26	88
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	26	—
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	44	365
	44	365
	44	365
	61	71
	76	77
	189	190
	192	193
	220	220
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No.	Identified	Received or Rejected
		Page of Transcript
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	134	136
	134	136
	134	136
	26	—
	26	—
	26	—
	26	—
	26	—
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	26, 159	164
	26, 159	164
	26	—
	26	—
	26	—
	26	—
	26	—
	26	—
	26, 167	168 (reject
	114	138
	139	—
	225	249
	312	338
	412	412

No. 22,286

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

TRANSAMERICA EQUIPMENT LEASING CORPORATION, a Texas Corporation,

Appellant,

vs.

UNION BANK, a California corporation,

Appellee.

Appeal From a Judgment of the United States District Court, Central District of California, Honorable Manuel L. Real, United States District Judge.

BRIEF OF APPELLEE.

FILED

SEP 3 1968

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Rules

Statutes

Textbooks

No. 22,286

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vs.

UNION BANK, a California corporation,

Appellee.

Appeal From a Judgment of the United States District Court, Central District of California, Honorable Manuel L. Real, United States District Judge.

BRIEF OF APPELLEE.

Introductory Statement.

As will be demonstrated hereinbelow, the appeal consists almost in its entirety of an attack upon the findings of the trial court. Totally ignoring the "clearly erroneous" standard (Rule 52(a), F.R.C.P.), appellant studiously selects and argues only those portions of the evidence favorable to it, contending that because particular findings are or may be contrary to these particular items of evidence, considered separately and without regard for the totality of the evidence, these findings must be wrong. The technique ignores fundamental precepts of federal appeals; more pertinently, it ignores the great bulk of testimony and nec-

essary inferences therefrom. It will necessitate a somewhat extended counter-statement of the case, in order to put the items referred to into context and perspective.

Statement of the Case.

A. Nature and Course of the Proceedings.

The action was filed as one for breach of a "certain written Loan Agreement" annexed to the complaint, alleged to have been entered into by the parties "after numerous negotiations" [Compl. p. 2, R. 3].[1] Execution and delivery of the instrument was admitted, but its claimed character as a binding contract was denied [Ans. p. 1, R. 112].

Defendant alleged that various express conditions precedent set forth in the Loan Agreement had failed to occur [Ans. pp. 2-3; R. 113-114]. Following a special pre-trial conference on the limited question of the rule of damages applicable in the event liability was established [Stip. and Order, October 11, 1965, R. 172] the third cause of action was withdrawn. A regular pre-trial conference was held October 10, 1966 [Pre-trial Conf. Order, R. 215]. At the latter conference, plaintiff sought to rely on both the written Loan Agreement and on an alleged oral agreement between the parties to make the same loan, about a week before, supported by the writing as a memorandum sufficient to satisfy the Statute of Frauds, and defendant contended that the existence of the alleged oral agreement was not in issue under the pleadings and "applicable rules of law" [Pre-trial Conf. Order, pp. 3-4, R. 217-218].

The case was tried for three days, the trial judge admitting evidence referable to both the negotiation

[1]References to the record transmitted by the clerk will be prefaced by "R"; references to the reporter's transcript of proceedings by "Tr."

of the written agreement referred to in the complaint and pre-trial order and the alleged verbal agreement, over objections addressed to the parol evidence rule [e.g. Tr. 23-24]. At the conclusion of plaintiff's case, plaintiff elected to rely upon the alleged verbal agreement, supported by the Loan Agreement as a memorandum sufficient to satisfy the Statute of Frauds [Tr. 394, 402; see also 421-422, 431].

Judgment was for defendant, and, after plaintiff's motion for new trial was denied [R. 324, 327], it appealed.

B. Disposition of Case in Court Below.

In support of the judgment, the trial judge prepared and signed his own findings of fact and conclusions of law [R. 311-321]. In essence, he found that defendant had verbally offered to make a loan to plaintiff subject to a series of conditions, one of which was that the terms and conditions of the transaction were to be reduced to writing and the writing was to constitute the agreement of the parties [Finds. XI, XIa, R. 316-317]. He found that before plaintiff communicated its assent to the writing the offer was withdrawn [Finds. XII, XIII, R. 318-319], that the terms and conditions for repayment of the loan, an essential part of the contemplated loan agreement, were not agreed upon and were expressly reserved for further negotiation and agreement [Finds. XIV, R. 319] and that particular additional conditions relating to a concurring engineering report and an approving title opinion failed to occur [Finds. XVII, XVIII, R. 319-320]. He thus concluded that any verbal agreement between plaintiff and defendant prior to the writing would be barred and unenforceable by reason of the statute of frauds [Concl. II, R. 320], that the written loan agreement was not binding because prior to plaintiff's as-

sent thereto defendant communicated an oral refusal to make the loan [Concl. III, R. 320], that any offer by defendant to make the loan was withdrawn and the withdrawal communicated to plaintiff prior to plaintiff's acceptance thereof [Concl. IV, R. 321], that the written loan agreement was not binding upon the parties because it reserved for future negotiation and agreement the terms and conditions upon which the loan would be repaid, which terms and conditions were essential terms of the contemplated loan transaction [Concls. V, VI, R. 321], and that defendant was thus not guilty of any breach of contract with plaintiff [Concl. VII, R. 321].

C. Statement of Facts Relevant to Issues Presented for Review.

1. *The parties.* Plaintiff and appellant Transamerica Equipment Leasing Corporation ("plaintiff" herein) is a Texas corporation, with no more than one active principal, formed shortly before the subject transaction occurred, and apparently continued in existence solely for the purpose of prosecuting this litigation. In essence, it was a "shell" corporation formed to handle three-party financing transactions in the oil and gas field [Tr. 19, 89-94]. Witness Chipman was its president and one of its two principal shareholders, the other being inactive [Tr. 18, 89-90].

Defendant and appellee Union Bank ("defendant" herein) is a California corporation, having a separate department for petroleum loans [Tr. 24, 204, 211, 212]. During the latter portion of the period from May, 1962, to August, 1963, witness Fiedorek was acting head of the petroleum department; in August 1963, witness Smith became acting head of the department [Tr. 205, 212-213]. Neither Fiedorek nor Smith had

lending authority and plaintiff had knowledge of this fact; the contemplated loan transaction required approval by Louis Siegel, defendant's senior executive vice president [Tr. 56, 111, 293-294; R. 216]. Witness Breakstone was associate counsel of defendant; his function was that of a lawyer and not of a lending officer [Tr. 363, 391].

Ancora Corporation ("Ancora" herein), plaintiff's customer, was the general partner in a series of limited partnerships having interests in the Citronelle oil field in Alabama. Among these limited partnerships were Citronelle Unit No. 1, Ltd. and Citronelle Unit No. 3, Ltd., referred to in the testimony but not involved in the case, Citronelle Unit No. 4, Ltd., the proposed borrower, and Aladon Company, Ltd., the proposed borrower in a succeeding transaction [Tr. 20, 29-30, 95-96]. One Harold Green was head of Ancora [Tr. 20].

2. *Definition of terms.* Certain technical terms used throughout the trial were defined by the witnesses as follows:

> Reserves—recoverable oil and gas under the ground [Tr. 230].
>
> Primary reserves—reserves which are produced by natural energy present in the oil reservoir, *i.e.,* natural water drive, gas expansion, gravity draining and solution gas expansion. Reserves classifiable as primary may be produced either by means of these natural forces alone, or by these forces in conjunction with ordinary pumping [Tr. 226].
>
> Secondary reserves—those reserves which are produced only by means of some form of energy transmitted to the reservoir from an outside source or surface, such as water injection, gas injection or thermal recovery [Tr. 227, see also 216].

Secondary recovery unit—a group of lessees producing oil and gas by secondary recovery methods from the same reservoir, and distributing the proceeds equitably among the lessees whose wells are used to inject the water or gas and those lessees whose wells are used for production [Tr. 228].

Developed reserves—reserves underlying wells that are drilled and producing [Tr. 220].

Undeveloped reserves—reserves which exist, but which cannot be produced without drilling or providing the means of transmitting the energy necessary for production [Tr. 229]. Undeveloped secondary reserves would thus be reserves which may be recoverable in the future, but only after a secondary recovery operation is established and put into effect [Tr. 231].

Approving title opinion—a term used among oil and gas lawyers to identify the requirement of a lender upon or purchaser of oil and gas properties that it be furnished either with a policy of title insurance or an opinion from a reputable law firm to the effect that the borrower or seller has good and marketable title to the properties [Tr. 386].

Other technical terms appearing in the two engineering reports, Plaintiff's Exhibits 5 and 17, are defined at Transcript pages 234-235 and 258-259.

3. *The critical events.* The evidence focused upon three critical events, a meeting at defendant's offices on August 21, 1963, a series of meetings on September 12 and 13, 1963 and a series of telephone conversations on September 19 and 20, 1963.

(a) Having determined that he would put together a three-way loan transaction among plaintiff, Ancora and defendant, on the basis of a general exploratory

conversation in May, 1963, no commitment having been asked or given at the time [Tr. 24-27, 105, 109-110, Pltf. Ex. 1], Chipman set up a meeting with defendant in Los Angeles on August 21, 1963, and a separate meeting with Ancora in San Francisco on August 22, 1963 [Tr. 32, 36, 120]. Prior to departing Dallas, he prepared a form for a letter of agreement with Ancora [Tr. 120-121, 122, Def. Ex. A] and initiated preparation of compendious implementing documentation, utilizing forms prepared originally for an earlier transaction negotiated by him on behalf of his former employer [Tr. 37-38, 129, 374].

(b) Chipman met with Smith and with Stoltz, also an employee of defendant, as scheduled, and ascertained from them defendant's interest in making a loan, and the basis upon which defendant would consider a loan application [*e.g.,* Tr. 33-36, 111-120, 213-217, 220-221]. He thereafter went to San Francisco, redrafted the pre-prepared letter agreement to delete referencs to the two wells which plainly could not meet defendant's standards (but not the lease payment schedule), and caused the redrafted instruments to be executed [Tr. 120-124, compare Pl. Ex. 2, Def. Ex. A]. Notwithstanding the definitive character of the letter agreement, neither Ancora nor plaintiff considered itself bound to the other [Tr. 316-317, 328, 410, Pl. Ex. 3, Def. Ex. B, Find. XIX, p. 10, R. 320].

(c) During the following three weeks, while an engineering report on the wells was being prepared by Fiedorek, Chipman continued with his predocumentation of the transaction, causing copies of the documents between plaintiff and Ancora to be executed and deposited with his attorney for retention in trust until the closing, and furnishing unexecuted copies of some of these documents to defendant [Tr. 37-38, 39, 40, 42,

43, 44, 46, 51, 134, 142-143, 364-366, Pl. Ex. 4, see also Pl. Exs. 7, 9, 10].

(d) On September 12 and 13, 1963, Chipman returned to Los Angeles to meet with defendant, review proposed documentation, and obtain approval of the proposed loan transaction [Tr. 283, but see 48, *et seq.*] At this time, defendant advised him that the Fiedorek report, although it described reserves sufficient to support the loan, could not be used alone because of objections that might be raised in view of Fiedorek's status as a consultant to the bank. A further report was required [Tr. 55, 58, 286-288, 290]. Schafer Engineering of Dallas, Texas, was consulted and the required arrangements were made [Tr. 59, 290, 295]. Because defendant had originally approved Fiedorek, and because Chipman reacted bitterly to the imposition of the further requirement, defendant undertook to pay Schafer's fee [Tr. 58, 59, 288, 293, 353]. Siegel testified that he told Chipman that if Schafer concurred with Fiedorek defendant would consider the loan [Tr. 354]; other witnesses said that the statement was to the effect that the loan would be made [Tr. 58-59, 293].

(e) During the balance of the series of meetings, because Chipman continued to press for a commitment and for the earliest possible closing [Tr. 313, 353, 379, see also Pl. Ex. 16], considerable time was spent on documentation. The written Loan Agreement was blocked out, and Breakstone agreed to cause it to be typed and to be sent to Chipman in Dallas, to be held by him pending Breakstone's arrival there on other business [Tr. 50-54, 144, 380-381, Pl. Ex. 11]. Chipman's proposed documentation was approved as to form, subject to such substantive changes as might be required in order to conform it to the final provisions of the loan agreement [Tr. 364-367, 374-375, see also

391]. Because of difficulties relating primarily to the disposition to be made of Ancora's first payment of $22,920.00, which both plaintiff and defendant wanted to retain, and the manner of payment of defendant's loan fee of $11,550.00, no repayment schedule was established, and the entire subject was reserved for further discussion [Tr. 324-325, 383-384, 391, Pl. Ex. 11(iii), see point I, *infra*]. Breakstone outlined to Chipman the balance of defendant's requirements for closing (*i.e.*, title opinion, certificates, releases, etc.) [Tr. 380, 385] and Chipman returned to Dallas to await Schafer's findings, meanwhile continuing with his work on documentation [Tr. 59]. In the event Schafer concurred and the loan was to be made, a "closing" was scheduled at Chipman's request for Mobile, Alabama, on September 23, 1963 [Tr. 144, 369, 378-380].

(f) The proposed written Loan Agreement was prepared, executed on behalf of defendant, and mailed to plaintiff. Chipman signed the original and placed it and all copies in his file [Tr. 77, 78, 144-145, Pl. Ex. 11, 11(iii)].

(g) On September 19, 1963, the day before Chipman's deadline [Tr. 318, 378-379, see also 277], Schafer advised Smith by telephone that he did not concur with Fiedorek in his evaluation of the subject wells; he stated that he confirmed the values ascribed to the primary reserves but disagreed as to the secondary reserves. As to the latter, he found no basis for assuming, as had Fiedorek, that a secondary recovery unit would commence operations January 1, 1966, and could not on the basis of the data available to him confirm the validity of the secondary recovery efficiency factor that Fiedorek had used. He said the efficiency factor could possibly be confirmed by further research, but

until some unit was formed the date secondary recovery operations commenced would obviously be a matter of pure conjecture. Notwithstanding, Schafer submitted, in case defendant "was interested in that", his estimate of the value of the "possible" secondary reserves, and confirmed his entire report in writing [Tr. 261-263, 265, 298, 299-300, 319-322, Pl. Ex. 17, see also point IV, *infra*].

(h) On September 19, Smith telephoned Chipman and advised him that defendant was unwilling to make the loan because Schafer had not concurred with Fiedorek in respect to the evaluation of the secondary reserves [Tr. 61-64, 300-301, Pl. Ex. 24]. Chipman frantically telephoned Fiedorek [Tr. 72], Schafer [Tr. 72, 268] and telephoned Breakstone twice, the second time with his attorney on the line [Tr. 73, 147, 370, 372, Pl. Ex. 25]. Although Siegel, concerned with what Breakstone considered "veiled threats" of litigation, told Smith and Breakstone that the loan was not to be made under any circumstances [Tr. 357, 360, Pl. Ex. 29, but see Tr. 305], this was not communicated to Chipman; rather, he was invited to obtain and furnish further engineering data if he so desired [Tr. 80, 306, 307, 308, 321, but see 74, 75]. Had Schafer, on the basis of further investigation, concurred with Fiedorek, defendant, reluctantly because of Chipman's litigious attitude, would have made the loan [Tr. 322, 360]. No further engineering data was sought [Tr. 277]. Instead, Chipman attempted unsuccessfully to obtain the loan elsewhere [Tr. 80, 158-161].

ARGUMENT.

I.

The Parties Expressly Reserved for Future Negotiation and Agreement the Terms and Conditions Upon Which the Subject Loan Would Be Repaid. These Were Essential Terms of the Loan Transaction. Accordingly, the Purported Agreement Was Not Binding Upon the Parties. The Judgment Below Must Be Affirmed on This Basis Alone.

The trial court found that defendant verbally offered to lend $600,000 to plaintiff on six wells, on various terms and conditions, one of which was:

> "(d) Said loan . . . was to be paid in installments over a period of 42 months *according to a schedule to be worked out and mutually agreed upon by and between plaintiff and defendant.*" (emphasis supplied). [Find. XI, pp. 6-7, R. 316-317].

It further found that

> "(g) Any proceeds of production received by defendant by virtue of the . . . assignment of runs would be applied, first, to the monthly payment on the fee note, second, to the monthly payment on the principal note, not exceeding, however, *the monthly payment set forth in the schedule to be agreed to by and between the parties,* and third, after deducting an amount or percentage for operating expenses to be agreed upon by the parties, to a special reserve account not to exceed $75,000, . . ." (emphasis supplied). [Find. XI(g), R. 318].

From this it concluded:

> "V
>
> "The written loan agreement, dated September 18, 1963, is not binding upon the parties because it reserves for future negotiation and agreement of the parties the terms and conditions upon which the subject loan would be repaid, which said terms and conditions of repayment were essential terms of the contemplated loan transaction." [Concl. V, R. 321].

Plaintiff's attack on the foregoing findings and conclusion is two-pronged; it contends that all that was left for future determination was an internal allocation by defendant of plaintiff's payments, and that this allocation was not an essential term of the contract (App. Op. Br. p. 6). Much of the evidence adduced at the trial was directed to this issue. Notwithstanding its duty to prove the findings "clearly erroneous", plaintiff has made no effort to summarize or analyze any of the evidence and its arguments blithely ignore the findings. Even though specifically rejected by the trial court's findings of fact, plaintiff's contention is argued as if no such findings exist.

It is, of course, the duty of an appellant, when challenging the substantiality of the evidence to support findings made by the trial court, to fairly set forth *all* the material evidence, not merely its own partisan version of what came before the trial court. (*Conderback, Inc. v. Standard Oil Co.,* 239 Cal. App. 2d 664, 687, 48 Cal. Rptr. 901 (1966); *Atlas Terminals, Inc. v. Sokol,* 203 Cal. App. 2d 191, 209, 21 Cal. Rptr. 293 (1962). This court is not required to search the record to uncover support, if any, for an appellant's claim that findings lack evidentiary support (*e.g., Green v. Green,* 215 Cal. App. 2d 31, 35, 30 Cal. Rptr. 30

(1963), and cases there cited), nor can such a duty be thrust upon appellee (*Wiley v. Wiley*, 183 Cal. App. 2d 588, 591, 7 Cal. Rptr. 73 (1960); *Hickson v. Thielman*, 147 Cal. App. 2d 11, 14-15, 304 P. 2d 122 (1956).

California courts, applying a standard of appellate review of findings comparable to that of Rule 52(a), F.R.C.P., hold that where an appellant defaults in his burden of presenting to the court a fair statement of the evidence, it has waived its claim that findings are not supported by substantial evidence (*Rogers v. Whitson*, 228 Cal. App. 2d 662, 674, 39 Cal. Rptr. 849 (1964); *Arditto v. Putnam*, 214 Cal. App. 2d 633, 640-641, 29 Cal. Rptr. 700 (1963); *Zint v. Topp Industries, Inc.*, 184 Cal. App. 2d 240, 243, 7 Cal. Rptr. 302 (1960); *Murphy v. Hartford Acc. & Ind. Co.*, 177 Cal. App. 2d 539, 542, 2 Cal. Rptr. 325 (1960), and is foreclosed from questioning the sufficiency of the evidence to support the findings (*McKeon v. Santa Claus, etc., Inc.*, 230 Cal. App. 2d 359, 362-363, 41 Cal. Rptr. 43 (1964)).

A repayment schedule for a petroleum loan must accommodate the borrower's desire to retain surplus revenue, the lender's desire for substantial payments and adequate collateral, and the declining productive capacity of the wells. Thus, the engineering report and its projection of cash flow becomes critical [Tr. 107, 325-326]. Chipman prepared his first proposed schedule before his August trip, before any engineering projection was available, and prepared further proposed schedules as information was developed [Tr. 109, 112, 122]. Until Schafer confirmed Fiedorek's cash flow pro-

jections, and the parties agreed on the disposition of all lease payments, it would have been premature to attempt to prepare a final schedule.

Very substantial areas of disagreement existed. Ancora's first payment to plaintiff was $22,920.00; with respect to this payment Breakstone testified:

> "Well, when we were in Mr. Smith's office discussing the loan there was a considerable hassle over the repayment of the loan and as to the schedule.
>
> "The first problem was Mr. Chipman wanted the first payment for himself. Mr. Smith indicated that he would like to have the bank have it. Mr. Chipman stated that he wanted the first payment which was part of his commission in putting this deal together for Ancora and that based on the schedules that he worked out, that he, Mr. Chipman had worked out, the bank would be paid in 42 months. Mr. Smith did not agree to give up that first payment that Mr. Chipman was talking about." [Tr. 383].

On the same subject, Smith testified:

> "Q. Do you recall, Mr. Smith, any discussion between you and Mr. Chipman on September 12 or September 13, 1963 with regard to the question whether the first installment payment on the lease and promissory note from Ancora to Transamerica should or should not be paid to Union Bank in repayment of its loan? A. Yes, there was some discussion about who would get the first payment.
>
> Q. Do you recall what that discussion was? A. Transamerica wanted that first lease payment so that they wouldn't have to wait until the tail end of this thing to realize any cash. I was not convinced that we should give that up to them.

Q. Did you indicate to Mr. Chipman that you were not convinced that you should give it up to them? A. Yes, I did. This was something that was going to be negotiated, the first lease payment.

Q. To your knowledge was that point resolved? A. It was not resolved. No, sir.

Q. What was the amount of that first lease payment? A. I believe it was $22,000." [Tr. 324-325].

On the subject of the defendant's loan fee, Mr. Breakstone testified:

"Then secondly we executed for compensating balances a fee note of $11,550 which was to be incorporated into the schedules and to be paid in 42 equal installments. This was discussed in great detail. There was some discussion in the beginning that we would have Chipman pay the $11,550 off the top if he was going to take the first payment, he could pay us the loan fee right off the top. He didn't want to do that, he wanted to stagger it. We discussed it but never came to any conclusions as to how it should be done. This was one of the items which Mr. Chipman discussed with me late in the afternoon on Friday the 13th, September, 1963 when we were discussing the loan agreement." [Tr. 384].

Mr. Breakstone thus concluded:

"We left the matter of the schedule open because we couldn't agree on it. He didn't know how he wanted to do it, he wanted to think about it. He said he would prepare a new schedule and send it to us for our consideration." [Tr. 384].

Plaintiff's arguments totally disregard the foregoing testimony, which was uncontradicted.

Following the conversation referred to, Breakstone prepared and transmitted to Chipman the proposed written Loan Agreement, which provided *inter alia* as follows:

> "3. Said loan, evidenced by the aforesaid promissory note, shall be paid in installments over a period of forty-two (42) months *according to a schedule to be worked out and mutually agreed upon by and between the parties hereto.*" (emphasis supplied) [Pl. Ex. 11(iii), p. 2].

Plaintiff's various proposed payment schedules [*i.e.,* Pl. Ex. 4(a), 16 and 21] were not only not agreed to; they were plainly insufficient to provide for the payment of the loan during its term. Had defendant received the first 42 note payments and lease payments 2 through 43, as plaintiff proposed, it would have received a total of $670,255.94 [Pl. Ex. 4(a), p. 3]. Plaintiff's computation of the amount needed to repay its loan was $683,050 [Tr. 323], a difference of almost $13,000. The schedule proposed in plaintiff's Exhibit 16 fell $16,600 short [Tr. 414]. Plaintiff suggested in oral argument and suggests now in argument (App. Op. Br. 38) and in the schedule annexed to its brief[2] that the matter could be handled by a "balloon" payment of $16,406 in the last month [Tr. 399]. Ancora's payment to plaintiff during this month was to be only $7,843.94 [Pl. Ex. 4(a), p. 3]; plaintiff furnished no indication that it would or could make up the deficiency, and there was no evidence that defendant was willing to proceed on the assumption that a source of payment of the deficiency would be found.

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[2]The source of this schedule is not apparent. It was not an exhibit in evidence or otherwise referred to at the trial. Plaintiff apparently created it for the purpose of its brief (App. Op. Br. p. 28).

Plaintiff argues that Ancora assigned to it all of the runs, and that it in turn proposed to make an equivalent assignment to defendant. From this it apparently concludes that all of the scheduled payments were *minimum* payments and that if anything was to be determined, it was solely a matter of internal allocation of the gross payments (App. Op. Br. pp. 4-5, 21-26). This construction of the instruments would undoubtedly shock the parties, particularly Ancora, the borrower.

In the first place, although a full *security interest* in the runs was to be transferred [Pl. Ex. 4(a), p. 10, see also App. Op. Br., pp. 4-5][3], the transfer was to be made only as security for the indebtedness described. The indebtedness consisted of two items, the lease payments described in Exhibit 4(a), page 3, Subp. (a), and the installment note payments described in the same exhibit, page 3, Subp. (b). The lease referred to was in evidence as Exhibit 4(b) and the installment note as Exhibit 4(d).

All of these instruments refer to fixed payments and not to minimum payments, as plaintiff would now have us believe. The note contains no "on or before" clause.

Plainly, the parties contemplated that surplus monies would go not to defendant, as plaintiff now contends, but to plaintiff or Ancora. That this is so is clearly demonstrated by the Loan Agreement [Pl. Ex. 11(iii)], which provides in Paragraph 8, pages 3-4, as follows:

> ". . . both notes shall be paid monthly out of runs from the producing properties mortgaged and assigned to Bank. Application of proceeds there-

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[3]The abstract quoted at Appellant's Opening Brief, pages 4-5, is inaccurate. The quoted language is found in Exhibit 4(a), not in 4(d), and omits without indication one-half page of text following the word "Mortgagee" in the first line of Appellant's Opening Brief, page 5.

> from shall be as follows: First on the monthly payment due on Note 'B,' and the balance remaining to be applied first on interest and then on principal as to Note *'A,' not exceeding, however, as to Note 'A,' the monthly payment set forth in the schedule* to be agreed to by and between the parties hereto. After application of proceeds as aforesaid, any excess remaining in any given month after deducting therefrom a given amount or percentage for operating expenses shall be retained by Bank and deposited in a special reserve account for Borrower, provided, however, that *said reserve account shall at no time be in excess of Seventy-Five Thousand Dollars* ($75,000.00). . ." (emphasis supplied).

If plaintiff's contention were correct, the limitation imposed upon the amount of the payment on Note "A" and the further limitation on the amount of the reserve would be meaningless.

Further, defendant was not even party to the documentation upon which plaintiff's analysis is based. Only Ancora and plaintiff were party to Exhibits 4(a), 4(b), 4(c) and 4(d). Breakstone approved unexecuted copies of these as to form, but testified that insofar as matters of substance were concerned, the Loan Agreement would control and these documents might require amendment by interlineation to conform to it [Tr. 364, 367, 374-375, 391]. In approving the documentation Breakstone was acting in his capacity as an attorney, and did not have authority to bind the Bank [Tr. 363, 391]. Similarly, the proposed documentation by which plaintiff's rights were to be transferred to the Bank [Pl. Exs. 21, 22 and 23], although similarly reviewed in blank by Breakstone and approved by him as to form [Tr. 364-366], was subject to change with re-

spect to matters of substance [Tr. 367, 374-375]. The principal substantive matter left open for determination at the time, and therefore the matter most likely to cause changes in the pre-documentation, was the matter of the payment schedule [*e.g.,* Tr. 383-384].

Admitting that the trial court found to the contrary, plaintiff argues (App. Op. Br., 27-28) that the parties treated the schedule as a matter of no importance. The argument flies in the face of all of the evidence on the subject. The necessity for agreement on the schedule was referred to in two different places in the Loan Agreement (Paras. 3 and 8). It was the subject of an extended discussion among Chipman, Breakstone and Smith [Tr. 325, 383-384]. The agreement on September 13 was that Chipman was to think about the Bank's proposal, prepare a new schedule and send it for consideration [Tr. 384]. Until he did so there was no reason for Smith to discuss the matter with anyone. There was no logical reason for the subject to be discussed in memoranda or in conversations devoted to other subjects.

The terms of repayment are, of course, essential elements of a loan agreement. No bank will lend money unless a borrower is under a clear, definite and legally enforceable obligation to repay. Where, as here, an essential element of an agreement is expressly left open to future negotiation and agreement, the court may not supply the missing terms or remove the uncertainty. It will not imply or speculate as to what the parties might have agreed to, or substitute terms of its own, however reasonable. It will not enforce the "Agreement" or award damages for its breach.

> *Ablett v. Clauson,* 43 Cal. 2d 280, 272 P. 2d 753 (1954);
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> *Autry v. Republic Productions, Inc.,* 30 Cal. 2d 144, 180 P. 2d 888 (1947);

Levy v. Firks, 222 Cal. App. 2d 429, 433, 35 Cal. Rptr. 207;

Alaimo v. Tsunoda, 215 Cal. App. 2d 94, 29 Cal. Rptr. 806 (1963);

Louis Lesser Enterprises, Ltd. v. Roeder, 209 Cal. App. 2d 401, 404-405, 408, 25 Cal. Rptr. 917 (1962);

Roven v. Miller, 168 Cal. App. 2d 391, 335 P. 2d 1035 (1959);

Roberts v. Adams, 164 Cal. App. 2d 312, 330 Pac. 900 (1958);

Putnam v. Cameron, 129 Cal. App. 2d 89, 276 P. 2d 102 (1954);

Bonk v. Boyajian, 128 Cal. App. 2d 153, 274 P. 2d 948 (1954);

Gould v. Callan, 127 Cal. App. 2d 1, 5, 273 P. 2d 93 (1954);

Colorado Corp., Ltd. v. Smith, 121 Cal. App. 2d 374, 263 P. 2d 79 (1953);

Burgess v. Rodom, 121 Cal. App. 2d 71, 262 P. 2d 335 (1953);

Vangel v. Vangel, 116 Cal. App. 2d 615, 254 P. 2d 919 (1953);

Avalon Products, Inc. v. Lentini, 98 Cal. App. 2d 177, 219 P. 2d 485 (1950);

Bravo v. Sharkey, 97 Cal. App. 2d 883, 218 P. 2d 785 (1950);

Kerr Glass Corp. v. Elizabeth Arden Corp., 61 Cal. App. 2d 55, 141 P. 2d 938 (1943);

Blake v. Mosher, 11 Cal. App. 2d 532, 54 P. 2d 492 (1936);

Dillingham v. Dahlgren, 52 Cal. App. 322, 198 Pac. 832 (1921);

Jules Levy & Bro. v. A. Mautz & Co., 16 Cal. App. 666, 669, 117 Pac. 936 (1911);

Klein v. Citizens Union Nat. Bank, 281 Ky. 650, 136 S.W. 2d 770 (1940);

Smith v. Dotterweich, 116 N.Y.S. 896, 132 App. Div. 489 (1909); rev. other gr. 93 N.E. 985 (1911);

1 Williston on Contracts, Third Ed., §45, pp. 149-150.

Avalon Products, Inc. v. Lentini, supra, is squarely in point. There, the court stated:

> "Where, however, there has been no agreement upon an essential element and the contract provides no means for the determination thereof but leaves it to the future negotiation and agreement of the parties, the contract is void * * * Although a greater degree of certainty is required in a contract which is sought to be specifically enforced, the general rule is that a provison in a contract which leaves open the terms of payment for future negotiation renders the contract incomplete and uncertain in one of its material features, and for that reason unenforceable in equity. * * * In California, the rule is the same and no action will lie to enforce the performance of a contract or to recover damages for its breach unless it is complete and certain. * * *
>
> "The purchase order involved herein specifically provides that the method of payment is to be agreed upon before delivery. An essential element of the contract is thus left to future negotiation and agreement of the parties. If prior to delivery either party should insist upon terms of payment which the other is unwilling to meet neither party

> could enforce the contract. Since appellant repudiated the contract before there was complete agreement, respondent cannot recover damages for its breach." 98 Cal. App. 2d at 179-180.

The decision in *Avalon Products, Inc. v. Lentini,* relating specifically to terms of payment in a credit-sale situation, is but one application of a rule of contract construction well settled in this State. As the Supreme Court stated in *Ablett v. Clauson, supra,* a case involving a controversy with respect to the validity of a clause claimed to confer an option to renew a lease:

> "The general rule regarding contracts to agree in the future is stated to be as follows: 'Although a promise may be sufficiently definite when it contains an option given to the promissor or promissee, yet if an essential element is reserved for the future agreement of both parties, the promise can give rise to no legal obligation until such future agreement. Since either party by the terms of the promise may refuse to agree to anything to which the other party will agree, it is impossible for the law to affix any obligation to such a promise.'* * *" 43 Cal. 2d at 284-285.

In *Autry v. Republic Productions, Inc., supra,* the California Supreme Court stated:

> "There is no dispute that neither law nor equity provides a remedy for breach of an agreement to agree in the future. Such a contract cannot be made the basis of a cause of action. * * * The court may not imply what the parties will agree upon. * * *" 30 Cal. 2d at 151-152.

Two decisions of the California District Courts of Appeal may be said to be the leading cases in support of the above general proposition. The first of these is *Dillingham v. Dahlgren, supra,* an action for damages for breach of a purported contract to sell certain real property to the plaintiff. Here, although a written "agreement" existed, the record showed that the parties intended preparation of a further formal agreement, including additional substantial terms, and the court held that even though where a final contract fails to express some matter, as, for instance, a time of payment, the law may imply the intention of the parties, where a preliminary contract leaves certain terms to be agreed upon for the purpose of a final contract, there can be no implication of what the parties wll agree upon (52 Cal. App. at 329-330).

> Accord: *Vangel v. Vangel,* 116 Cal. App. 2d 615, 254 P. 2d 919 (1953).

The other leading California authority is *Kerr Glass v. Elizabeth Arden Corp., supra,* an action for damages for failure to erect a building according to the terms of a lease. Under the terms of the "agreement" in question, the plaintiff had agreed to lease portions of a building to be constructed by the defendant, preliminary plans and specifications were attached to the agreement, and there was a provision that the defendant would prepare final plans and specifications that would be approved by the parties, a provision that such approval would not unreasonably be withheld, and a provision that the final plans and specifications would then become part of the agreement. The Court held that the

foregoing did not constitute an enforceable agreement because essential final terms remained to be agreed upon. The Court refused to engage in any implication as to what the parties would be willing to agree upon in the future.

> Accord, *Louis Lesser Enterprises, Ltd. v. Roeder, supra;*
> *Colorado Corp., Ltd. v. Smith, supra;*
> *Bravo v. Sharkey, supra;*
> *Putnam v. Cameron, supra.*

In the case last cited, the Court stated:

> "* * * Where the minds of parties litigant have not met on an essential element of the purpose to be achieved, and they have failed to specify the means for determining such element but have indicated that future negotiations are necessary to effect an agreement, the abortive effort, however labeled, is void * * *" 29 Cal. App. 2d at 95.

The general rule above enunciated has had application in a variety of situations analogous to that involved in the case at bench.

Thus, *Roberts v. Adams, supra,* involved a lease from Adams as lessor to Roberts as lessee, containing an option reading as follows:

> "It shall be a condition of this tenancy that the Lessee, Charles Roberts, shall have the option to purchase the said property as per Map recorded in Book 19, pages 1-34, for the total sum of $85,000.00, *payable as mutually agreed by both parties.*" (Emphasis by Court.)

There was testimony that there were certain conversations about terms of payment, but the evidence showed that these conversations (if they occurred) were merged

into the writing when, at defendant's request, plaintiff placed in the agreement the phrase "payable as mutually agreed by both parties". On these facts the Court held that in the absence of any internal or external indicia of what the parties would have agreed upon, the Court could not supply the omitted provision, for that would amount to making a contract for the parties. Its decision, it stated, was an application of the firmly established law of California that failure to specify or furnish a standard for determination of terms of payment and method of securing the unpaid balance of the purchase price of real or other property is fatal to its enforceability, notwithstanding any desire of the courts to be liberal and helpful. (164 Cal. App. 2d at 315).

A clear distinction is made by the cases between the situation where an uncertainty exists that can be cured by the Court either by reference to extrinsic evidence or by implication as to what the parties would have agreed upon and an item reserved for further negotiation and future agreement of the parties. In the latter situation, the Court will not seek to determine what the agreement of the parties would have been, but rather holds their contract to be incomplete and unenforceable.

Roberts v. Adams, supra;

Jules Levy & Bro. v. A. Mautz & Co., supra.

Plaintiff relies upon various decisions which are fully consistent with the general rule of law set forth hereinabove. Moreover, these cases also uniformly hold that the time and manner of payment is an essential term of any agreement where credit is extended. We have found and plaintiff has cited no cases to the contrary.

City of Los Angeles v. Superior Court, cited by plaintiff at page 22, distinguishes between so-called "essential elements" and matters deemed unessential. The matters there left to the future agreement of the parties were plainly minor in light of the principal purposes of the contract involved and bear no analogy to the matters here reserved for future agreement. In following the decision in *City of Los Angeles,* the Supreme Court stated in *Metropolitan Water District v. Marquart,* 59 Cal. 2d 159, 28 Cal. Rptr. 724, 379 P. 2d 28 (1963) that the rule is that

> "Although a promise gives rise to no legal obligation if an essential element is reserved for future agreement, the enforceability of the contract containing a promise to agree depends upon the relative importance and severability of the matter left to the future . . ." (59 Cal. 2d at 194).

Plainly, in a loan transaction the mode of repayment is neither severable nor non-essential. See also *Pacific Hills Corp. v. Duggan,* 199 Cal. App. 2d 806, 19 Cal. Rptr. 291 (1962), distinguishing *City of Los Angeles* on this basis.

Wong v. Di Grazia, cited by plaintiff at page 23, dealt with "a minor possible ground of disagreement in an otherwise complete agreement", as plaintiff points out. Further, it dealt with a very remote contingency, the possibility that a concededly non-essential term of the contract might not be agreed upon within the period fixed by the rule against perpetuities. The Court's resolution of this question is of no assistance in dealing with the problem faced in the case at bench.

Mancuso v. Krakov, discussed at page 23, does not assist plaintiff. No essential terms was left open for future agreement, but rather, the Court's comments have reference to the computation of the total price of goods, based upon fixed and readily determinable elements.

Burrow v. Timmsen, discussed at page 24, involved not an agreement to obtain a loan but rather, a routine land sale transaction wherein the seller agreed to take back a note and deed of trust. As the abstract quoted by plaintiff discloses, the essentials of the agreement, the amount of the trust deed *and the terms of payment,* were agreed upon, and the Court deemed it proper to imply matters, not expressly provided for, which had become established canons of real estate law.

Stockwell v. Lindeman, discussed at page 25, is to the same effect; it is to be noted that the opinion expressly indicates that in a credit transaction the time and manner of payment is an essential term that must be agreed upon.

Plaintiff's cases illustrate the rules applicable in credit transactions involving the sale of land. While all details of the contract need not be set forth with particularity, the essential terms must be and the time and manner of payment constitute essential terms. The teaching of these cases is clear and the analogy obvious; in a contract for a loan as in a contract for the sale of land on credit, the time and manner of payment constitute essential terms and if these are left to the future agreement of the parties themselves the contract is uncertain and therefore unenforceable.

II.

Reliance Upon Any Oral Agreement Is Precluded by the Statute of Frauds.

A. Plaintiff Having Changed Its Theory of Its Case After All Evidence Was in, Defendant Had No Opportunity to Raise the Statute of Frauds and Cannot Be Held to Have Waived It by Failing to Do So.

It is the law, as plaintiff suggests, that a defendant waives its right to rely upon the statute of frauds by failing to demur to the complaint, failing to object to the introduction of evidence to prove the oral contract at the trial, or by failing to make a motion to strike such evidence.

> *E.g., Pao Ch'en Lee v. Gregeriou,* 50 Cal. 2d 502, 326 P. 2d 135 (1958).

Waiver, of course, consists of the voluntary relinquishment of a known right and presumes the existence of an opportunity to act. Nothing in the record reflects any voluntary relinquishment of any right by defendant to rely upon the statute, nor does it indicate any opportunity given to defendant to voice any such objection. To the contrary, the record demonstrates that plaintiff's reliance upon an oral contract was in the nature of an afterthought, after evidence properly admitted was in and the opportunity to move to strike such evidence had passed. Thus:

1. Plaintiff's complaint was based upon alleged breach of the *written loan agreement,* attached to the complaint as an exhibit, and incorporated by reference therein (Complaint, paragraphs II, V. First Cause of Action; VII, Second Cause of Action; IX, Third Cause of Action; R. 3, 4, 5).

2. At the pre-trial, for the first time, plaintiff contended that there was an oral agreement, *and a written*

memorandum thereof sufficient to obviate any objection based upon the statute of frauds [Pretrial Order, Par. VIA, pp. 3-4, R. 217-218], and defendant argued that even this contention was outside the issues framed by the pleadings [Pretrial Order, Pars. VI, VII-I, pp. 3, 8, R. 217-222]. At this juncture, plaintiff made no contention that it relied upon an oral agreement, independent of the "loan agreement".

3. At the trial, evidence as to the negotiations and discussions of the parties came in, properly, *over defendant's objection* [Tr. 23-24] as bearing upon the identity of the subject matter of the contract, to explain the meaning of the ambiguous, abstruse, and technical terms used, and to demonstrate the intention of the parties in the light of the circumstances existing at the time of execution (see, *e.g.*, *Ellis v. Klaff*, 96 Cal. App. 2d 471, 476, 216 P. 2d 15, (1950)). Indeed, in articulating his objection counsel for defendant specifically acknowledged the propriety of admitting such evidence for this limited purpose.

4. After plaintiff rested, the court asked counsel for plaintiff to make an election between the written contract and the oral contract and, after hesitating, counsel stated that he relied on the oral agreement. When the court stated that reliance on an oral contract was precluded by the statute of frauds, counsel replied that the statute was inapplicable not because of any waiver but because of the written memorandum (the "Loan Agreement") signed by defendant, the party to be charged [Tr. 402, 431]. Plaintiff continued to so contend in its post-trial memorandum [p. 16, lines 14-21, R. 270].

5. In its post-trial memorandum, *for the first time*, plaintiff suggested the possibility that it could rely upon the oral discussions of the parties as constituting an

oral agreement, without reference to any written memorandum [p. 17, lines 11-13, R. 271].

In other words, plaintiff contended for the first time after the trial had ended that evidence properly admitted to explain and clarify the written Loan Agreement should be utilized to find an oral contract, not supported by any written memorandum, and now contends that defendant cannot assert the statute of frauds because it had not objected to the admission of such evidence on this basis. Until plaintiff announced its intention to rely upon the claimed oral agreement, independent of any written memorandum, there was no occasion for defendant to assert the statute. Manifestly, defendant cannot be held to have waived the statute by having failed to make a premature objection to evidence then admissible, because plaintiff failed to complete the proof and belatedly changed its theory.

E. K. Wood Lumber Co. v. Moore Mill & Lumber Co., 97 F. 2d 402, 408 (9 Cir. 1938);

San Francisco Brewing Corp. v. Bowman, 52 Cal. 2d 607, 618, 343 P. 2d 1 (1959);

Gard v. Ramos, 23 Cal. App. 303, 304, 138 Pac. 108 (1913);

See also:

Ellis v. Klaff, 96 Cal. App. 2d 471, 474, 216 P. 2d 15 (1950).

"The evidentiary consequences of the statute of frauds (Civ. Code, §1624) are in many respects similar to those of the parol evidence rule (Code Civ. Proc., §1856). Both require exclusion of extrinsic evidence which would vary, contradict, or add to the terms of the written agreement under consideration (*Craig v. Zelian,* 137 Cal. 105 [69 P. 853], statute of frauds; *Germain Fruit Co. v. Armsby Co.,* 153 Cal. 585 [96 P. 319], parol

evidence rule), but both permit reception of such evidence to identify the subject matter of the contract from the written description, explain the meaning of ambiguous, abstruse, or technical expressions, and assist in interpreting the expressed intentions of the parties in the light of circumstances existing at the time of execution. * * * It must be recognized, however, that there is a basic distinction between the two rules, which, in certain circumstances, becomes of controlling significance.

* * *

"The statute of frauds, on the other hand, is designed to prevent fraud and perjury by requiring certain contracts to be evidenced exclusively in writing. In order to effectuate that purpose, it demands that every material term of an agreement within its provisions be reduced to written form, whether the parties desire to do so or not. To be sufficient, the required writing must be one 'which states *with reasonable certainty,* (a) each party to the contract . . . and (b) the land, goods or other subject-matter to which the contract relates, and (c) *the terms and conditions of all the promises* constituting the contract and by whom and to whom the promises are made.' * * * Unless the writing, considered alone, expresses the essential terms with sufficient certainty to constitute an enforceable contract, it fails to meet the demands of the statute. * * * Accordingly, where the statute of frauds, rather than the parol evidence is invoked, it follows that recovery may not be predicated upon parol proof of material terms omitted from the written memorandum, even though the oral understanding is entirely consistent with, and in no way tends to vary or con-

tradict, the written instrument. * * * In the words of the Supreme Court, 'The whole object of the statute would be frustrated if any substantive portion of the agreement could be established by parol evidence.' * * *" (*Ellis v. Klaff, supra,* 96 Cal. App. 2d at 475-477, emphasis by court).

B. Plaintiff May Not Rely Upon the Loan Agreement as a Memorandum Satisfying the Requirements of the Statute of Frauds.

Plaintiff, if we comprehend its present position correctly, is seeking to rely upon Siegel's categorical statement that plaintiff "has itself a loan" as a contract and upon the Loan Agreement [Ex. 11(iii)] as a written memorandum satisfying the statute of frauds, if such a memorandum be required. The dilemma thus created may not be escaped. The memorandum conclusively demonstrates the absence of a contract (Point I, *supra*), and absent a memorandum, the contract is invalid (Cal. Civ. Code §1624).

Plaintiff's effort to fill in the gaps by means of the reference in the Loan Agreement to other documentation is unwarranted. For example, plaintiff's contention to the contrary notwithstanding, there was and is no reference to Exhibit 22, the proposed Assignment of Equipment Lease, Promissory Note and Mortgage Lien, the only document purporting to transfer the promissory note or any interest therein.

C. The Trial Court Did Not Misapprehend Evidence Bearing on the Alleged Oral Agreement.

Plaintiff suggests that the trial court misapprehended the evidence bearing on the oral agreement when

it commented that Chipman himself testified that he did not think he had an agreement with defendant when he left the Bank on the 13th (App. Op. Br. p. 20). Plaintiff challenges us to find something remotely resembling this statement in the record.

Without doubt, the Court referred to a statement, not by Mr. Chipman in open court, but rather in the course of his telephone conversation with Mr. Chandler, his attorney, and Mr. Breakstone, on September 20, 1963, a transcript of which is in evidence as Plaintiff's Exhibit 25. Mr. Chipman's characterization of his understanding on the 13th was expressed by him on that occasion as follows:

> "Chipman: 'But, Mr. Sigel made a—I don't like to say commitment—because, I'll use it—but, I'm using it because I don't know of a better word to use at the moment. He did not make a true commitment, eh,—but, nevertheless, Mr. Sigel made a statement—a very positive statement—based on Fiedorek's work—
>
> "Breakstone: 'That's right.'" [Pl. Ex. 25, p. 2]

Casual statements by the court during the course of trial or argument are not equivalent to findings; only the latter may be deemed to constitute the basis of the Court's decision. *Wincar Welders v. Leebrick*, 186 Cal. App. 2d 195, 198-199, 8 Cal. Rptr. 846 (1960). To the extent that the Court relied, even subjectively, upon Chipman's belief, its decision was based not upon myth but upon evidence far more credible than that given by Chipman in Court.

III.

The Finding That the Terms and Conditions of the Contemplated Loan Transaction Were to Be Reduced to Writing Was Supported by Substantial Evidence: the Tender of the Proposed Written Agreement Was Therefore an Offer, Which Could Be and Was Withdrawn.

Both plaintiff and defendant were fully aware that a written loan agreement would be required. In this connection, Chipman testified:

"Q. Did you and Mr. Breakstone commence the drafting of a loan agreement at that time between yourself and the Union Bank? A. I don't recall that we did but a loan agreement was discussed.

Q. Were the terms of it discussed? A. In a general way. The loan agreement was a normal proceeding for the bank, particularly this size a transaction. He recited the documents necessary but I did not see a paper called a loan agreement." [Tr. 53].

Breakstone testified:

"Q. Did you also have any discussion at that time concerning a written loan agreement? A. Yes. We had decided that there would have to be a loan agreement. He agreed to it.

I started to draft it in outline form for him. I did not have the time, being Friday afternoon. to whip out or to get out, to dictate an agreement.

I discussed with him what would basically go into it. I said I would prepare the agreement and I would have it signed by the bank and mailed to him but there would be conditions in it that would have to be met. He agreed to this procedure. We did this only for the purpose of convenience to

Mr. Chipman because he was emphasizing time was of the essence. I did then prepare a loan agreement on Monday or Tuesday. I believe the following Wednesday it was mailed to him, probably the 18th or 19th of September." [Tr. 380-381].

"It is the rule that where the oral agreement contemplated the execution of a formal written contract by signing, either party has the right to insist on the condition, and mere acts on the part of one who has not signed will not validate the contract. * * * *Spinney v. Downing,* 108 Cal. 666 [41 P. 797], says (p. 688):

> 'It is a general rule to which this case presents no exception that, when it is a part of the understanding between the parties that the terms of their contract are to be reduced to writing and signed by the parties, the assent to its terms must be evidenced in the manner agreed upon or it does not become a binding or completed contract. This is essentially true when, as here, the proposed contract contains reciprocal stipulations and covenants upon the part of each as a consideration for the acts of the other.'

"The foregoing was quoted in the recent case of *Kessinger v. Organic Fertilizers, Inc.,* 151 Cal. App. 2d 741, 749 [312 P. 2d 345].

"Williston says and quotes from *Sparks v. Mauk,* 170 Cal. 122 [148 P. 926], thus:

> 'It may also be supposed that the written contract was made and was signed by but one party, although a signing by both parties was contemplated. " 'It is the undoubted rule that where the contract contemplates the execution of it by signing, either party has the right to insist

upon the condition, and mere acts of performance upon the part of one who has not signed will not validate the contract' " '. (1 Williston on Contracts, 67, §28A.)

"Furthermore a contract in writing signed by the parties takes effect only on delivery. * * *

"Section 1933 of the Code of Civil Procedure reads: 'The execution of an instrument is the subscribing and delivering it, with or without affixing a seal.'

"In re *Quartz Crystal Products Co.,* 71 F. Supp. 949, says that (p. 951): 'The Courts of California and the Circuit Court of Appeals for the Ninth Circuit have held that this section means exactly what it says, i.e., its (sic) means *subscribing not by one party, but by all the parties who are required to sign it and delivering it to the party for whose benefit it is made or delivering it for record so as to make it notice to the world.'* This decision was affirmed by the Ninth Circuit Court of Appeals in 166 F. 2d 1023." (*Amer. Aero. Corp. v. Grand Cen. Aircraft Co.,* 155 Cal. App. (2d) 69, 80-81, 317 Pac. (2d) 694 (1957) [emphasis by court]).

Accord: *Louis Lesser Enterprises, Ltd. v. Roeder, supra,* 209 Cal. App. 2d at 405.

See also:

Apablasa v. Merritt & Co., 176 Cal. App. 2d 719, 726, 1 Cal. Rptr. 500 (1959).

In *Amer. Aero Corp., supra,* the issue was whether the agreement of the parties was the oral agreement found by the court or a different agreement manifested by an unsigned writing. The court found that the parties had agreed that their oral agreement be re-

duced to writing, signed by them and delivered, and that the oral agreement, *as made*, was not reduced to writing. The writing prepared did not reflect the agreement of the parties and, hence, the defendant refused to sign it. *Both* parties proceeded to perform but their performance was of the oral contract and not the proposed writing. The result was that the oral agreement remained binding (155 Cal. App. 2d at 83, quoted by plaintiff at page 31). Here, the court has found an *offer* to make a contract, which offer expressly contemplated the preparation of a writing, which writing was to constitute the agreement of the parties with respect to the subject matter thereof. The offer thus expressly excluded the possibility of an oral contract.

Plaintiff could not pick and choose among the elements of the offer of September 13, 1963, selecting those it found acceptable and rejecting those it found unacceptable. It had to accept all of the terms, including those relating to the writing.

> *Amer. Aero. Corp. v. Grand Cen. Aircraft Co., supra,* 155 Cal. App. 2d at 79.

Since one of the terms of the offer contemplated the preparation of a mutually acceptable writing, there was no contract until both parties acquiesced in the form and substance of the writing [Find. XIa, R. 316-317].

The court made no finding as to whether or not there was an oral agreement; in view of its ruling on the statute of frauds issue no such finding was required. The court's determination in that regard is nonetheless evident; any possibility it would find a ver-

bal agreement to have existed was plainly excluded by the express finding that defendant made a verbal *offer* to enter into a contract on a series of conditions, one of which was that

> "All of the terms and conditions of the contemplated loan transaction were to be reduced to writing and said writing was to constitute the agreement of the parties with respect to the subject-matter thereof." [Find. XIa, R. 316-317].

IV.

Non-Occurrence of Conditions Precedent to Defendant's Duty to Make the Loan Was Not Excused.

The trial court found that:

> "The engineering report prepared by Schafer Engineering, Petroleum Engineers, Dallas, Texas, did not concur with the aforesaid engineering report . . . (sic) prepared by Eugene C. Fiedorek, Dallas, Texas." [Find. XVII, R. 319].

The finding was plainly supported by substantial evidence [*e.g.*, Tr. 261-263, 320, compare Pl. Exs. 5, 17, and see Statement of the Case, para. C 3(g)].

Although Schafer's written report had not been received by defendant on September 19, 1963, defendant had been fully advised of its contents and of Schafer's non-concurrence on that date [*e.g.*, Tr. 262, 263]. Far from repudiating any contractual obligation it may have had to plaintiff at the time, defendant declined to perform in accordance with the terms of Paragraph 6A of the Loan Agreement, and invited plaintiff to furnish evidence that the condition could be met [Tr. 306-307, 322]. Smith categorically denied Chipman's statement that he had said the loan would not be made under

any conditions [Tr. 308] and Stolz, who had listened to the conversation on an extension telephone, confirmed this testimony [Tr. 409-410]. Smith testified that had the condition relating to the Schafer report been met subsequently, he would have recommended the loan [Tr. 322] and Siegel testified that he would have made the loan, albeit reluctantly [Tr. 360]. Defendant never communicated to plaintiff any refusal to perform the contract if the conditions were met, and certainly never communicated the "distinct, unequivocal, absolute refusal to perform the promise" required by the cases.

> *E.g.: California C. P. Growers v. Harris,* 91 Cal. App. 654, 656, 267 Pac. 572 (1928) and cases cited.
>
> 4 Corbin on Contracts, §§973-974, p. 905.

Even if the contract had been repudiated, Smith's expression of willingness to accept a report conforming to defendant's standards before the date set for performance reinstated plaintiff's obligation to tender performance (Cal. Civ. Code, §§1443, 1515).

Moreover, it is fundamental that to maintain its action for damages, plaintiff must prove its ability to perform the express conditions precedent. If plaintiff could not or would not perform, it is entitled to no damages. Its willingness and ability to perform remain conditions precedent in spite of any repudiation by defendant even though a tender of performance may be excused. Plaintiff proved neither its willingness and ability to furnish a concurring report nor its willingness and ability to deliver title to the properties involved. It therefore failed to prove its right to damages.

> *Gray v. Smith,* 83 Fed. 824, 829 (9 Cir. 1897);
> 4 Corbin on Contracts, §978, p. 924.

V.

None of the Trial Court's Findings Were "Clearly Erroneous"; to the Contrary, the Challenged Findings Were Supported by Substantial Evidence in Each Instance.

A. Finding XIa—the evidence in support of this finding is discussed, and citations to the record are set forth in Point III of this brief, *supra*.

B. Finding XIV—the evidence in support of this finding is discussed, and citations to the record are set forth in Point I of this brief, *supra*.

C. Finding XVII—the evidence in support of this finding is discussed, and citations to the record are set forth in Point IV of this brief, *supra*, and in the statement of the case, para. C3(a). Schafer failed to concur within the time limited by plaintiff [*e.g.*, Tr. 378, 379]. In view of his statement that he could not accept Fiedorek's guess as to the date of unitilization of the subject wells until a plan was adopted, he obviously could never fully concur [Tr. 263]. Schafer testified that with further study he could possibly concur in the postulated efficiency of secondary recovery procedures, but refused to accept without personal verification the results of the independent studies accepted by Fiedorek as valid [Compare Tr. 232-234 with Tr. 265-268]. Thus, Schafer characterized his conclusion as non-concurrence, and Smith, defendant's officer charged with the responsibility of evaluating Shafer's report, so construed the report [Tr. 261, 320]. The trial court accepted this testimony, and rejected Fiedorek's conclusion based upon his summary examination of Schafer's report [Tr. 223-224].

D. Finding XIb finds evidentiary support in the language of Paragraph 6A of the Loan Agreement [Ex. 11(iii); see also Tr. 119, 310-311].

E. Finding XIX—the issue was raised by the pleadings [Complaint, Par. VI, R. 2-3], and Pre-trial Conference Order [Paras. VIB, VIII, IX, and X, R. 219]. The finding is supported not only by Breakstone's testimony [Tr. 378] but also by Smith [Tr. 317], Stolz [Tr. 410], and the letter agreements between plaintiff and Ancora executed after plaintiff's Exhibit 2 [Pl. Ex. 3, Def. Ex. B].

F. Finding XI—the evidence in support of this finding is discussed, and citations to the record are set forth in Point III of this brief, *supra.*

G. Finding IX—the finding plainly relates not only to Exhibit 16, but also to Exhibits 4a through 4d, inclusive, 21, 22 and 23. Thus the reference is to plaintiff's proposal that it retain the first lease payment and payments 44 through 48, assigning payments 2 through 43 to defendant as security and as a partial source of repayment of its loan [see, *e.g.,* Pl. Ex. 21].

H. Finding XV—the evidence in support of this finding is discussed, and citations to the record are set forth in Point I of this brief, *supra.*

Conclusion.

Defendant's shot-gun attack ignores in many instances the findings of the trial court and in almost every instance the substantial evidence underlying the findings. The case was tried with meticulous care by the trial judge, and the decision is in accordance with the evidence. Plaintiff raises no substantial issues of law. Accordingly, the decision below should be affirmed.

Respectfully submitted,

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No. 22,286

IN THE

United States Court of Appeals
For the Ninth Circuit

TRANSAMERICA EQUIPMENT LEASING CORPORATION, a Texas corporation, *Appellant,* vs. UNION BANK, a California corporation, *Appellee.*	

Appeal from a Judgment of the United States District Court
for the Central District of California
Honorable Manuel L. Real, Judge

APPELLANT'S REPLY BRIEF

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No. 22,286

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Appeal from a Judgment of the United States District Court for the Central District of California Honorable Manuel L. Real, Judge

APPELLANT'S REPLY BRIEF

---

1. THE ORAL AGREEMENT IS NOT BARRED BY THE STATUTE OF FRAUDS.

A. The Defense of the Statute of Frauds Was Not Claimed When It Could Have Been Claimed. This Is a Waiver.

The Trial Court held that any oral agreement was barred by the Statute of Frauds. But this was not a contention which defendant made at the trial. In its opening brief, plaintiff pointed out that the Trial Court had no authority to donate an optional remedial defense to a defendant who had not claimed it. De-

fendant, in its brief, does not deny that the defense was not claimed. It argues, however, that it did not have "any opportunity" to make the claim because "plaintiff's reliance upon an oral contract was in the nature of an afterthought, after evidence properly admitted was in and the opportunity to move to strike such evidence had passed." (Brief, p. 28.)

Defendant does not explain how it was possible for the Judge to seize on the point during the trial (Tr. 402, 431, 449) even before defendant put on its case, if the issue was raised too late for the defendant to have any opportunity to voice its objection.

Defendant offered five reasons to support its claim that plaintiff's reliance on the oral agreement was "an afterthought". None of the reasons is valid.

(a) Complaint.

Defendant says the complaint was based on the written loan agreement. (Brief, p. 28.) Paragraph III of the complaint expressly refers to the oral commitment. (R. 3.)

(b) Pretrial Order.

Defendant states that "at the pretrial, for the first time, plaintiff contended that there was an oral agreement *and a written memorandum thereof sufficient to obviate any objection based upon the statute of frauds* [Pretrial Order, Par. VIA, pp. 3-4, R. 217-218]. . . . At this juncture, plaintiff made no contention that it relied upon an oral agreement, independent of the 'loan agreement'." (Brief, pp. 28-29, emphasis in original.)

Defendant's summary of the pretrial order is not true.

The portion of the pretrial order cited by defendant said that the plaintiff contended an issue to be tried was whether there was an oral contract. There was *no* reference in that portion of the pretrial order to any written memorandum "sufficient to obviate any objection based on the statute of frauds." The only reference to a writing was to whether all of the terms of the oral contract were incorporated in and integrated in a writing so as to forbid extrinsic evidence under the parol evidence rule. This is clearly stated in the pretrial order at paragraph VII(I). (R. 322.)

> "Plaintiff contends that the following issue of law is to be litigated upon the trial . . .
>
> If it is determined that there was an oral agreement made on or about September 13, 1963, by Louis Siegel for defendant and C. Lee Chipman for plaintiff, and if some of the terms of such agreement were reduced to writing and embodied in a memorandum, may extrinsic evidence relating to the discussions and negotiations of the parties be admitted to add to or vary the terms of such memorandum?"

There is absolutely nothing here to support defendant's italicized phrase. The pretrial order shows squarely that defendant was on notice, before trial, that plaintiff proposed to rely on an oral agreement.

(c) Defendant's Objections.

Defendant states that evidence of negotiations and discussion came in over defendant's objection. (Brief,

p. 29.) There is a single objection cited. This objection, at Tr. 23-24, was directed to evidence of preliminary negotiations in January and February of 1963 relating to a potential transaction involving a different borrower. Defendant never made any objection to the evidence on the negotiations and agreements in September, 1963, relating to the borrower involved in this case, and relating to the oral agreement in issue in this case. Defendant's statement that such evidence was admitted for a limited purpose is not true.

(d) Plaintiff's Hesitant Election.

Defendant states that "After plaintiff rested, the court asked counsel for plaintiff to make an election between the written contract and the oral contract and, after hesitating, counsel stated that he relied on the oral agreement." (Brief, p. 29.) Defendant argues that plaintiff then stated that the Statute of Frauds was inapplicable because of the written memorandum.

Here again, defendant's argument is predicated upon an alleged fact which on an examination of the record turns out not to exist. Far from there being any hesitation, the record shows that plaintiff's counsel repeatedly and emphatically stated that he was proceeding on the oral agreement. The reliance was articulated not only at the conclusion of plaintiff's case (Tr. 394) but in the opening statement (Tr. 12). There was no reference to reliance on any writing. Similarly, in its Memorandum of Contentions of Fact and Law submitted for the pretrial, plaintiff did not state that it was relying on any written agreement. (pp. 18-19.)

It is true that plaintiff, in the course of argument, suggested to the Court that there was a memorandum which would in any event take the oral agreement out of the Statute of Frauds. Plaintiff's position obviously was in the alternative.

(e) Post-Trial Memoranda.

Defendant states that the oral agreement was asserted by the plaintiff for the first time in its post-trial memoranda. Defendant says that defendant could not be held to have waived the statute by having failed to make an objection because of this tardy assertion of plaintiff's claim.

Of course, defendant's argument here is contradicted by its own prior admission that the contention was made at the pretrial and the trial and in argument before the Court. It is also contradicted by the fact that the Court recognized, during the trial, that the Statute might be applicable to plaintiff's claim.

Defendant cites four cases to support its argument that it could not be deemed to have waived the statute. The cases do not support its position. In *Gard v. Ramos,* (1913) 23 Cal.App. 303, 304, the defendant expressly pleaded the bar of the statute at the end of its case. In *San Francisco Brewing Corp. v. Bowman,* (1959) 52 Cal.2d 607, 618, the defendant requested that the jury be instructed on the statute of frauds. In neither case was the defense ignored completely as the defendant did here. In *E. K. Woods Lumber Co. v. Moore Mill & Lumber Co.* (9th Cir. 1938) 97 F.2d 402, the Court indicated that the statute of frauds defense was raised when there was a denial of the contract

in defendant's answer. The Court indicated that defense was not waived under such circumstances. This 30-year-old case is not a correct statement of California law. See *Pao Ch'en Lee v. Gregoriou* (1958) 50 Cal. 2d 502. *Ellis v. Klaff* (1956) 96 Cal. App.2d 471, cited by defendant and quoted at length, has no discernible relevance to the specific issue here involved.

It is thus apparent that defendant's argument that it could not have claimed the statute of frauds is false. It could have claimed the defense; it failed to do so. That failure is a waiver.

Defendant asserts in its brief that absent a memorandum the contract is "invalid" citing California Civil Code Sec. 1624. (Brief, p. 32.) That, of course, is the same error which the Trial Court made. It has been repeatedly held that Sec. 1624 means merely that a contract not executed in conformity with the statute of frauds is not void but merely voidable. *Payton v. Cly,* (1960) 184 Cal.App.2d 193; *Zimmerman v. Bank of America,* (1961) 191 Cal.App.2d 55. If the defense is not raised by a proper claim, then, like any other contract which may be disaffirmed but is not, the oral agreement is valid.

B. Even If There Were No Waiver, the Statute of Frauds Was Satisfied by Written Memoranda.

Plaintiff's position is that an oral contract was made and that any objection based on the statute was waived. But if there was no waiver then, in the alternative, plaintiff contends that the written memoran-

dum signed by defendant would be sufficient to satisfy the statute.

Defendant contends that the several memoranda cited by plaintiff do not amount to a contract. (Brief, p. 32.) Its contention, however, is based on its *ipse dixit* that Exhibit 22 is not referred to in the "loan agreement". Paragraph 2B of the "loan agreement" refers to an Assignment of Lease. Exhibit 22, which Mr. Breakstone examined and approved before writing the "loan agreement," is the only document which fits that description. Defendant would have us believe that Mr. Breakstone's reference is not to the document he saw, reviewed and had in his possession, but to another non-existent document.

C. The Trial Court Misapprehended Evidence Bearing On the Oral Agreement.

Plaintiff noted in its brief that the Court grossly misapprehended testimony of Mr. Chipman. The Court repeatedly stated that there had been *direct testimony* that Mr. Chipman did not believe he had made an oral agreement on September 13. Defendant replied that when the Court spoke of direct testimony it really was referring to a transcript of a telephone call. (Brief, p. 33.)

This is sophistry. The Court alluded to direct testimony at the trial, not to a telephone call transcript. (Tr. 418, 419, 432.)

Nor does the telephone conversation quoted by defendant support its contention. The full colloquy is as follows:

"Breakstone: Well, as I say, I'm not the Judge and the jury, but I'm cognizant of what's happened, as I sat in on all of the negotiations, with the exception of the very beginning, and what transpired in the beginning, and so forth. But, it boils down to the fact that he (Smith) just changed his mind . . .

Chipman: That's the simple way to put it, and that really—really describes it best of all.

*   *   *   *   *

Breakstone: That's what he did, and he did it based on getting a proper concept of the engineering, which he didn't get when he read Gene's report. Now, I will say this, Gene didn't make it as clear as Shafer did.

Chipman: But, Mr. Siegel made a—I don't like to say commitment—because, I'll use it—but I'm using it because I don't know of a better word to use at the moment. He did not make a true commitment, eh,—but, nevertheless, Mr. Siegel made a statement—a very positive statement —based on Fiedorek's work.

Breakstone: That's right.

*   *   *   *   *

Chipman: I could only presume that Mr. Siegel had benefit of Fiedorek's report when he said 'if Shafer matches or exceeds Fiedorek's work, you've got a loan . . .'

Breakstone: Those—(laughter) those were his exact words.

Chipman: That's right.

Breakstone: *So, he wanted a check, and that's all.*"

(Plaintiff's Exhibit 25, p. 2. Emphasis added.)

It is perfectly obvious that Mr. Chipman and Mr. Breakstone were simply saying that the commitment was conditional; it was conditioned on the engineering report.

Of course, it is true, as defendant argues, that the Court's statements during a trial are not equivalent to findings. Yet it is also true that a finding may be erroneous if it derives from a gross misapprehension of the facts.

We have in this case the very clear statement by the Court that it understood a certain set of facts to exist and that it understood certain testimony to have been given. The transcript proves that the facts the Court believed to exist did not exist and that the testimony on which the Court relied had never been given. Findings which grew from such tainted ground can hardly be palatable.

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2. THE TERMS LEFT FOR FUTURE NEGOTIATION WERE NOT ESSENTIAL TERMS.

The Trial Court stated, as a conclusion of law, that the written loan agreement was not binding because "essential terms" had been reserved for future negotiation. (R. 321.) Plaintiff argued that the term left for future negotiation was not "essential". Defendant's riposte is to berate plaintiff for not treating the Conclusion of Law as a Finding of Fact. (Brief, pp. 12-13.)

Defendant quoted two findings (Brief, p. 11) and implied that the Conclusion of Law could not be ques-

tioned until the two findings were first shown to be clearly erroneous. But the two findings have nothing to do with the Conclusion of Law. The quoted findings purport to list some of the terms of the so-called "offer" of September 12-13. They do not interpret the written loan agreement or the oral agreement.

The legal issue here is whether the term left for future negotiation was essential. Defendant's brief ultimately addresses itself to this issue. (pp. 19-27.) After reviewing the law, it concludes with the truism that the time and manner of payment of a loan are essential terms. (p. 27.) No one disputes such a statement. But that was not the term left for future negotiation in this case. As demonstrated in plaintiff's brief, the term left open related to the bank's allocation of the payment to be made. The Court clearly stated that its understanding of the law was that such an internal allocation was "essential". (Tr. 445.) Such an internal allocation is not the same as the terms for "the time and manner of payment of a loan." One relates to the accounting for the payments received; the other to the right to receive specific payments and to enforce that right. One is not essential because it does not affect the economics of the transaction. The other is essential because it determines precisely what the lender can compel the borrower to pay.

Defendant does attempt to argue that the excluded term was broader than an internal allocation. Defendant quotes testimony to show that on September 13 there was no agreement at all on the method of paying the "fee note". (Brief, p. 15.) Defendant studi-

ously avoids mentioning that the parties had agreed that the method for payment of the fee note would be selected by the Bank (Finding XI(f), R. 318) and that the Bank made its selection in Mr. Breakstone's letter of September 18. (Exhibit 11.)

Defendant also says that the disposition of the initial equipment lease payment was unsettled. (Brief, p. 14-15.) There is no finding on this point. Nor does defendant's statement comport with the facts. The Assignment of Lease (Exhibit 22), which defendant approved "as to form", expressly stated that plaintiff, as assignor, excepted from the assignment "the first installment of rental provided for in said Equipment Lease" (Exhibit 11, paragraph 1.1.A). That Assignment was included by reference in paragraph 2.B of the written loan agreement which defendant sent to plaintiff on September 18, 1963. Moreover, it is perfectly obvious that the schedule of payments mentioned in paragraph 8 of Exhibit 11 could not apply to such initial lease payment. The reason is that the schedule applied only to the application of the runs of oil from the producing properties. (Exhibit 11, paragraph 8, line 5.) The initial lease payment was not payable out of such runs. As stated in the Equipment Lease (Exhibit 4), it was an amount due on delivery and withheld from the sums to be advanced to Ancora. The difference is not trivial. As noted in plaintiff's opening brief, and not challenged by defendant, it was agreed that the Bank's loan was to be repaid only out of runs from producing properties (p. 27, Tr. 389-390) and thus the schedule of pay-

ments in the "loan agreement" could not involve the initial Lease payment.

Defendant's brief states that the schedule of minimum payments[1] would result in a deficit. (Brief, p. 16.) But defendant persistently ignores the realities of the agreement. The engineering reports showed that the expected runs were more than ample to pay the loan and the Assignment of runs showed that it was these *gross* runs which were to be assigned to the Bank. Defendant says there was no source of payment of the "deficiency" if only the minimum payments were retained by Bank. Why does it think there was to be a reserve accumulation out of runs of $75,000. (Exhibit 11, paragraph 8.)

Defendant says, in response to the demonstration that the schedule set forth only minimum payments, that "this construction of the instruments would undoubtedly shock the parties, particularly Ancora . . ." (Brief p. 17.) Defendant's "undoubtedly" is undoubtedly false. Ancora would not be shocked because the agreements it signed very clearly and explicitly said that all of the runs were assigned, not only to the extent of the minimum monthly payments, but to pay the indebtedness "In such manner as Mortgagee may elect . . . regardless of whether such payments exceed the payments of principal and interest provided to be paid in said indebtedness . . ." (Exhibit 4A, 11-12.) Defendant scoffs at this language. Its refutation is that the Ancora note contains no "on or before"

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[1]Defendant, in a footnote on p. 16, complains that the schedule was not referred to at trial. See Tr. 396, lines 13-14.

clause. (Brief, p. 17.) But the note states that reference must be made to the mortgage to determine the extent of the security and the rights of the holders of the note. Would Bank seriously contend that the language quoted would not avail to give the Mortgagee the power to use the runs to make payments "regardless of whether such payments exceed the payments of principal and interest" otherwise provided to be paid? Does defendant contend the language means nothing?

Defendant contends finally that "defendant was not even party to the documentation upon which plaintiff's analysis is based. Only Ancora and plaintiff were party to Exhibits 4A, 4B, 4C and 4D." (Brief, p. 18.) Obviously, the Bank was not a party to the instruments executed by plaintiff and Ancora. The Bank was simply the assignee of plaintiff. (Exhibit 11, paragraph 2B, Exhibits 21, 22 and 23.) But as assignee, it could get no more than the payments which its assignor was to receive from Ancora. The whole point is that Bank's payments were to be made out of Ancora's runs, and Bank, therefore, could only receive the runs which Exhibits 4A-D conveyed to plaintiff. The "essential terms" for the time and manner of payment are set forth in those Exhibits.

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3. DEFENDANT COULD NOT WITHDRAW ITS AGREEMENT.

Defendant does not meet a main thrust of plaintiff's argument that the Court erred in concluding that there was an offer which could be withdrawn.

The Court held that there was an offer which included, as one of its terms, that the agreement be reduced to writing. (Finding XI(a).) The finding did not require that the writing be signed or delivered. As noted in plaintiff's brief, defendant initially agreed that the writing need not be signed by plaintiff. (Opening Brief, p. 29.) Defendant has contended, and contends again in its brief, that *mutual execution* of the writing is an indispensable condition to any contract. Why?

The cases cited by defendant are inapposite because in those cases it was found that the parties contemplated that both would sign. The testimony quoted in defendant's brief does not show any such understanding and defendant earlier so conceded. (R. 244.) The Court's legal conclusion that the "offer" could be withdrawn before the writing was signed by plaintiff is therefore insupportable. Plaintiff's signature was simply not necessary.

Defendant also fails to meet the second point of plaintiff's argument. Defendant concedes that "the Court made no finding as to whether or not there was an oral agreement. . . ." (Brief, p. 37.) But defendant argues that it could not have found an oral agreement since it did find that there was an oral offer which required a writing. (Brief, p. 37-38.) The illogic is apparent. An offer on certain terms does not prohibit the making of an agreement on other terms. In any event, the Court failed to rule on a central issue and defendant cannot cure that failure by speculating about what the Court would have done if it had gotten around to the point.

4. DEFENDANT, IN CONTENDING THAT ITS REFUSAL TO MAKE THE LOAN WAS NOT ABSOLUTE, OR WAS LATER WITHDRAWN, IS IMPEACHING ITS OWN FINDINGS OF FACT.

The Court did not expressly find that the conditions precedent to the loan were, or were not, excused. The Court did find, however, that at all times since September 20, 1963, defendant has refused to make the loan. (R. 319.) Defendant busily cites evidence to the effect that defendant's refusal was not unequivocal, or that it cured its repudiation by subsequent expressions of willingness to perform. (Brief, p. 39.) It is interesting to see the appellee attack its own findings. It should be noted that the evidence cited by defendant relates to conversations *after* September 20, 1963. (Tr. 306-307.) The finding rejected such evidence because it expressly stated that defendant, "*at all times since September 20, 1963*" has refused to make the loan.

Plaintiff's argument was that the Court's Finding of Fact XVI was legally inconsistent with Finding of Fact XVII. Having determined that defendant refused to make a loan after September 20, 1963, the Court could not rule that plaintiff lost any rights by failing to perform any conditions after September 20. Defendant does not meet this argument. Instead, defendant now ingenuously contends that had the conditions been performed, it would have made the loan! (Brief, p. 39.) This should be remembered in considering defendant's earlier plaints that the contract was too uncertain to perform.

5. **CONCLUSION.**

The Court erred when it failed to rule on whether the parties had entered into an oral agreement.

The Court erred also when it determined, as a matter of law, that a written agreement was unenforceable because "essential" terms were omitted or because it could be withdrawn before it was signed by plaintiff.

Dated, San Francisco, California,
September 24, 1968.

Respectfully submitted,
ARTHUR J. LEMPERT,
Attorney for Appellant.

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RUDY E. VILLALOBOS, Petitioner-Appellant,	)	
vs.	)	No. 22288
FRED R. DICKSON, et al., Respondent-Appellee.	)	

APPELLEE'S BRIEF

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APPELLEE'S BRIEF

JURISDICTION

The jurisdiction of the United States District Court to entertain appellant's civil action under Title 42, United States Code, section 1983, was conferred by Title 28, United States Code section 1343(3). The jurisdiction of this Court is conferred by Title 28, United States Code section 1291.

STATEMENT OF THE CASE

Appellant, an inmate of Folsom State Prison, initiated an action under the Federal Civil Rights Act, 42 U.S.C. 1983, for general damages in the amount of $30,000, $10,000 to be assessed individually against Fred R. Dickson, Chairman of the California Adult Authority, and against William H. Madden and Abelicio Chavez, members of the Adult Authority. In addition, appellant sought

punitive damages in the amount of $30,000, $10,000 to be assessed individually against each of the named appellees. The complaint was filed in the District Court on May 19, 1967. (TR 1.) On the same day a summons was issued to the appellees. (TR 1.)

On August 14, 1967, the District Court ordered that appellees be granted an extension of thirty days in which to respond to the complaint (TR 13). Appellees filed on August 28, 1967, a motion to dismiss pursuant to Rule 12(b) of the Federal Rules of Civil Procedure on the ground that the complaint failed to state a claim against appellees upon which relief could be granted and a motion for summary judgment pursuant to Rule 56(b) on the ground that the complaint was sham and frivolous. (TR 23.) Appellant filed a motion in opposition on August 18, 1967 (TR 37).

In an order filed on August 20, 1967, after consideration of the complaint, the notice of motion and memorandum of points and authorities submitted by defendants, and other documents and papers submitted to the court by appellant, the court granted appellees' motion and dismissed the action pursuant to Rules 12(b) and 56(b) of the Federal Rules of Civil Procedure (TR 40).

SUMMARY OF APPELLANT'S ARGUMENT

1. The District Court improperly dismissed the complaint.

SUMMARY OF APPELLEES' ARGUMENT

I. The District Court properly dismissed the complaint as it fails to state a claim against defendants upon which relief can be granted.

II. The District Court properly dismissed the complaint as it is sham and frivolous.

ARGUMENT

I

THE DISTRICT COURT PROPERLY DISMISSED THE COMPLAINT AS IT FAILS TO STATE A CLAIM AGAINST DEFENDANTS UPON WHICH RELIEF CAN BE GRANTED

By his complaint appellant sought money damages from members of the California Adult Authority. The Adult Authority is a quasi-judicial body empowered by the Legislature to administer California's indeterminate sentence law. Cal. Pen. Code §§ 1168, 3020. In re McVickers, 29 Cal.2d 264 (1946). The members thereof are therefore absolutely immune from civil liability for acts performed within their quasi-judicial capacity. See Clark v. Washington, 366 F.2d 678, 681 (9th Cir. 1966); Robichaud v. Ronan, 351 F.2d 533, 536 (9th Cir. 1965); Belveal v. Bray, 253 F. Supp. 606, 608-609 (D. Colo. 1966). Appellant's

complaint fails to state a claim upon which relief can be granted for yet another reason. The revocation of appellant's parole and the refixing of his sentence at maximum in this case does not present a federal question. In re Costello, 262 F.2d 214 (9th Cir. 1958); cf. Spry v. Oberhauser, 361 F.2d 391, 392 (9th Cir. 1966); Ferchaw v. Tinsley, 234 F. Supp. 922, 924 (D. Colo. 1964). Thus, on either this ground or on the ground of official immunity, the District Court was correct in dismissing appellant's complaint.

Additionally, it should be noted that appellant by placing in issue the action of the Adult Authority returning him to prison as a parole violator is essentially attacking the legality of his confinement. Accordingly, his action should be in habeas corpus, not under the Civil Rights Act since to permit such an attack in an action under the Civil Rights Act would be to permit appellant to circumvent habeas corpus requirements. 1/ DeWitt v. Pail, 366 F.2d 682 (9th Cir. 1966); Johnson v. Walker, 317 F.2d 418 (5th Cir. 1963); Davis v. Maryland,

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1. Appellant has not raised the question of the revocation of his parole in the California Supreme Court although California does provide a remedy for wrongful revocation of parole. See, e.g. In re Hall, 63 Cal.2d 115 (1965). Accordingly, he has not exhausted an available state remedy, and his action if viewed as one in habeas corpus is premature. Title 28 U.S.C. § 2254.

248 F. Supp. 951 (D. Md. 1965). For this reason, too, the District Court properly dismissed appellant's complaint.

Finally, the fact that appellant brought his action in the District Court under the Federal Declaratory Judgment Act, 28 U.S.C. §§ 2201-02, is of no aid to him. The statute authorizing declaratory judgments in federal courts does not confer any added jurisdiction in the federal courts but merely enlarges the range of available remedies. Skelly Oil Co. v. Phillips Petroleum Co., 339 U. S. 667, 671-72 (1950).

II

THE DISTRICT COURT PROPERLY DISMISSED THE COMPLAINT AS IT IS SHAM AND FRIVOLOUS

There is no merit to plaintiff's assertion that parole was wrongfully revoked. Plaintiff was charged with three specific parole violations: using alcoholic beverages to excess, attempting an act of rape, and associating with persons of bad reputation. Plaintiff plead guilty to using alcohol to excess and associating with persons of bad reputation. See Clerk's Transcript, pp. 28-34. Therefore, the complaint was properly dismissed as it is sham and frilovous.

CONCLUSION

We respectfully submit the judgment of the District Court should be affirmed.

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MB:ck
SF CR 67-1238

CERTIFICATE OF COUNSEL

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, this brief is in full compliance with these rules.

Dated: December 28, 1967